

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report: N/A

Commission file number: 000-51380

**Silicon Motion Technology Corporation**

(Exact name of Registrant as specified in its charter)

**Cayman Islands**

(Jurisdiction of incorporation or organization)

**No. 20-1, Taiyuan St.,**

**Jhubei City Hsinchu County 302**

**Taiwan**

(Address of principal executive offices)

**Securities registered or to be registered pursuant to Section 12(b) of the Act:**

Title of each class	Name of each exchange on which registered
Ordinary Shares, par value US\$0.01 per share*	Nasdaq Global Market
American Depositary Shares, each representing four ordinary shares	

\* Not for trading, but only in connection with the listing on the Nasdaq Global Market of American Depositary Shares, or ADSs, each representing four ordinary shares.

**Securities registered or to be registered pursuant to Section 12(g) of the Act:**

None

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report: 123,780,268 ordinary shares, US\$0.01 par value per share.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.  Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Sections 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark which financial statement item the registrant has elected to follow.  Item 17  Item 18

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act): Yes  No

TABLE OF CONTENTS

<b><u>PART I</u></b>		1
ITEM 1.	<a href="#">IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS</a>	1
ITEM 2.	<a href="#">OFFER STATISTICS AND EXPECTED TIMETABLE</a>	1
ITEM 3.	<a href="#">KEY INFORMATION</a>	1
ITEM 4.	<a href="#">INFORMATION ON THE COMPANY</a>	17
ITEM 4A.	<a href="#">UNRESOLVED STAFF COMMENTS</a>	28
ITEM 5.	<a href="#">OPERATING AND FINANCIAL REVIEW AND PROSPECTS</a>	28
ITEM 6.	<a href="#">DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES</a>	41
ITEM 7.	<a href="#">MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS</a>	47
ITEM 8.	<a href="#">FINANCIAL INFORMATION</a>	47
ITEM 9.	<a href="#">THE OFFER AND LISTING</a>	48
ITEM 10.	<a href="#">ADDITIONAL INFORMATION</a>	49
ITEM 11.	<a href="#">QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</a>	53
ITEM 12.	<a href="#">DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES</a>	54
<b><u>PART II</u></b>		54
ITEM 13.	<a href="#">DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES</a>	54
ITEM 14.	<a href="#">MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND THE USE OF PROCEEDS</a>	54
ITEM 15.	<a href="#">CONTROLS AND PROCEDURES</a>	54
ITEM 15T.	<a href="#">CONTROLS AND PROCEDURES</a>	55
ITEM 16A.	<a href="#">AUDIT COMMITTEE FINANCIAL EXPERT</a>	56
ITEM 16B.	<a href="#">CODE OF ETHICS</a>	56
ITEM 16C.	<a href="#">PRINCIPAL ACCOUNTANT FEES AND SERVICES</a>	56
ITEM 16D.	<a href="#">EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES</a>	57
ITEM 16E.	<a href="#">PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS</a>	57
<b><u>PART III</u></b>		57
ITEM 17.	<a href="#">FINANCIAL STATEMENTS</a>	57
ITEM 18.	<a href="#">FINANCIAL STATEMENTS</a>	57
ITEM 19.	<a href="#">EXHIBITS</a>	57

## CONVENTIONS THAT APPLY TO THIS ANNUAL REPORT

Unless otherwise indicated, references in this annual report to:

- “ADRs” are to the American depositary receipts that evidence our ADSs;
- “ADSs” are to our American depositary shares, each of which represents four ordinary shares;
- “CAGR” are to compound annual growth rate;
- “China” or “PRC” are to the People’s Republic of China excluding the special administrative regions of Hong Kong and Macau;
- “Korea” are to the Republic of Korea, or South Korea;
- “Nasdaq” are to the Nasdaq National Market;
- “NT dollar,” “NT dollars” or “NT\$” are to New Taiwan dollars, the legal currency of Taiwan;
- “ROC” or “Taiwan” are to Taiwan, the Republic of China, the official name of Taiwan;
- “shares” or “ordinary shares” are to our ordinary shares, with par value US\$0.01 per share;
- “U.S. GAAP” are to generally accepted accounting principles in the United States;
- “U.S. dollar,” “U.S. dollars” or “US\$” are to United States dollars, the legal currency of the United States; and
- “we,” “us,” “our company,” “our” and “Silicon Motion” are to Silicon Motion Technology Corporation, its predecessor entities and subsidiaries including (i) Silicon Motion, Inc., incorporated in Taiwan, or SMI Taiwan, and formerly known as Feiya Technology Corporation and (ii) Silicon Motion, Inc., a California, USA, corporation, or SMI USA.

Silicon Motion, the Silicon Motion logo, FCI, the FCI logo, airRF, basicRF, ezRF, ezSYS, powerRF, twinRF, zipRF and zipSYS are our trademarks or registered trademarks. We may also refer to trademarks of other corporations and organizations in this document.

Unless otherwise indicated, our financial information presented in this annual report has been prepared in accordance with U.S. GAAP.

Solely for your convenience, this annual report contains translations of certain NT dollar amounts into U.S. dollars at specified rates. All translations from NT dollar to U.S. dollar amounts are made at the noon buying rate in the City of New York for cable transfers of NT dollars as certified for customs purposes by the Federal Reserve Bank of New York. Unless otherwise stated, the translation from NT dollars into U.S. dollars and from U.S. dollars into NT dollars has been made at the noon buying rate in effect on December 31, 2006, which was NT\$32.59 to US\$1.00. No representation is made that the NT dollar or U.S. dollar amounts referred to in this annual report could have been or could be converted into U.S. dollar or NT dollar amounts, as the case may be, at any particular rate or at all. See “Risk Factors — Fluctuation in exchange rates could result in foreign exchange losses” for discussions on how fluctuating exchange rates could affect our profitability and your investment in us. On June 28, 2007, the noon buying rate was NT\$32.82 to US\$1.00.

The “Glossary of Technical Terms” contained in Annex A of this report sets forth the description of certain technical terms and definitions used in this annual report. This annual report also contains statistical data and forecasted information that we obtained from industry publications and reports generated by International Data Corporation, or IDC. Industry publications generally indicate that they have obtained their information from sources believed to be reliable, but do not guarantee the accuracy and completeness of their information. Although we believe that the publications are reliable, we have not independently verified their data.

## SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This annual report contains forward-looking statements. These statements relate to future events or our future financial performance, our ability to continue to control our costs and maintain the quality of our products, the expected growth of and change in the semiconductor and multimedia consumer electronics industries worldwide, and involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to differ materially from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. These risks and other factors include those listed under “Risk Factors” and elsewhere in this annual report. In some cases, you can identify forward-looking statements by terminology such as “may,” “will,” “should,” “expect,” “intend,” “plan,” “anticipate,” “believe,” “estimate,” “predict,” “potential,” “continue” or the negative of these terms or other comparable terminology. A variety of factors, some of which are outside of our control, may cause our operating results to fluctuate significantly. They include:

- unpredictable volume and timing of customer orders, which are not fixed by contract but vary on a purchase order basis;
- the loss of one or more key customers or the significant reduction, postponement, rescheduling or cancellation of orders from these customers;
- general economic conditions or conditions in the semiconductor or multimedia consumer electronics market;
- our ability to successfully integrate our acquisition of Future Communications IC, Inc.;
- decreases in the overall average selling prices of our products;
- changes in the relative sales mix of our products;
- changes in our cost of finished goods;
- the availability, pricing and timeliness of delivery of other components and raw materials used in our customers’ products;
- our customers’ sales outlook, purchasing patterns and inventory adjustments based on consumer demands and general economic conditions;
- our ability to successfully develop, introduce and sell new or enhanced products in a timely manner; and
- the timing of new product announcements or introductions by us or by our competitors.

One or more of these factors could materially and adversely affect our operating results and financial condition in future periods. We cannot assure you that we will attain any estimates or maintain profitability or that the assumptions on which they are based are reliable.

Except as required by law, we undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise after the date of this annual report. All forward-looking statements contained in this annual report are qualified by reference to this cautionary statement.

**PART I**

**ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

Not applicable.

**ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

**ITEM 3. KEY INFORMATION**

**Selected Consolidated Financial Data**

You should read the following information with our consolidated financial statements and related notes and “Item 5. Operating and Financial Review and Prospects” included elsewhere in this annual report.

The selected consolidated statements of income and cash flow data for the years ended December 31, 2004, 2005 and 2006 and the selected consolidated balance sheet data as of December 31, 2005 and 2006 are derived from our audited consolidated financial statements included elsewhere in this annual report and should be read in conjunction with, and are qualified in their entirety by reference to, these consolidated financial statements and related notes. The selected consolidated statements of income and cash flow data for the years ended December 31, 2002 and 2003 and the selected consolidated balance sheet data as of December 31, 2002, 2003 and 2004 are derived from our audited consolidated financial statements which are not included in this annual report. These consolidated financial statements are prepared in accordance with U.S. GAAP.

[Table of Contents](#)

	Year Ended December 31,					
	2002	2003	2004	2005	2006	2006
	NT\$	NT\$	NT\$	NT\$	NT\$	US\$
	(in thousands, except for per share data)					
<b>Consolidated Statements of Income Data:</b>						
Net sales	456,874	915,070	2,166,727	2,686,492	3,460,459	106,182
Cost of sales	366,236	424,668	1,274,410	1,342,749	1,612,019	49,464
Gross profit	90,638	490,402	892,317	1,343,743	1,848,440	56,718
Operating expenses (income):						
Research and development	107,504	203,646	238,485	373,548	502,225	15,410
Sales and marketing	52,593	125,680	141,136	157,278	200,526	6,153
General and administrative	38,230	69,262	103,303	129,141	219,395	6,732
Amortization of intangible assets	8,048	24,145	17,758	4,501	—	—
Impairment of intangible assets(1)	—	54,143	11,718	—	—	—
In-process research and development	310,813	—	—	—	—	—
Restructuring charge	10,170	—	—	—	—	—
Compensation to customer	—	—	—	8,122	—	—
Write-off of other receivable(2)	—	—	—	—	40,039	1,229
Gain from litigation settlement	—	—	—	—	(3,000)	(92)
Total operating expenses	527,358	476,876	512,400	672,590	959,185	29,432
Operating income	(436,720)	13,526	379,917	671,153	889,255	27,286
Total non-operating income (expenses)	10,477	2,512	21,187	44,204	79,268	2,432
Income (loss) before income taxes	(426,243)	16,038	401,104	715,357	968,523	29,718
Income tax (benefit) expense	9,573	(94,405)	133,101	42,055	21,032	645
Net income (loss)	(435,816)	110,443	268,003	673,302	947,491	29,073
Weighted average shares outstanding:						
Basic	66,752	96,901	103,878	114,083	123,251	123,251
Diluted	66,752	96,901	103,878	116,015	125,488	125,488
Earning (loss) per share:						
Basic	(6.53)	1.14	2.58	5.90	7.69	0.24
Diluted	(6.53)	1.14	2.58	5.80	7.55	0.23
Earning (loss) per ADS(3):						
Basic earnings per ADS	(26.12)	4.56	10.32	23.61	30.75	0.94
Diluted earnings per ADS	(26.12)	4.56	10.32	23.21	30.20	0.93

(1) In 2003 and 2004 we determined that impairment of our intangible assets occurred as a result of a significant decline in expected net sales from new consumer products such as broadband Internet video phones, car navigation systems, and Tablet PCs. As the development and market for these products did not materialize, the forecasted sales and cash flows were significantly reduced.

(2) Write-off of a non-trade related receivable, the collection of which is doubtful.

(3) Each ADS represents four ordinary shares.

## [Table of Contents](#)

	As of December 31,					
	2002	2003	2004	2005	2006	2006
	NT\$	NT\$	NT\$	NT\$	NT\$	US\$
	(in thousands)					
<b>Consolidated Balance Sheet Data:</b>						
Cash and cash equivalents	358,440	763,545	727,165	1,581,993	1,808,042	55,478
Other current assets	267,802	459,634	1,324,343	2,341,402	3,141,162	96,384
Working capital	508,468	976,767	1,339,418	3,292,041	3,990,702	122,450
Long-term investments	17,027	7,195	3,142	15,954	170,942	5,245
Property and equipment, net	73,723	52,610	65,657	83,734	319,356	9,799
Intangible assets, net	116,368	38,080	6,843	—	—	—
Other non-current assets	31,529	41,281	39,887	65,048	89,182	2,738
Total assets	864,889	1,362,345	2,167,037	4,088,131	5,528,684	169,644
Total liabilities	135,246	253,754	718,804	638,346	960,561	29,475
Total shareholders' equity	729,643	1,108,591	1,448,233	3,449,785	4,568,123	140,169

	Year Ended December 31,					
	2002	2003	2004	2005	2006	2006
	NT\$	NT\$	NT\$	NT\$	NT\$	US\$
	(in thousands)					
<b>Consolidated Cash Flow Data:</b>						
Net cash provided by (used in) operating activities	(53,973)	128,322	234,703	539,008	596,763	18,311
Net cash provided by (used in) investing activities	(31,492)	9,706	(263,101)	(1,011,935)	(425,010)	(13,041)
Net cash provided by (used in) financing activities	12,353	268,562	(3,081)	1,278,868	59,929	1,839
Depreciation and amortization	19,541	28,210	21,734	23,906	35,596	1,092
Capital expenditures	(3,018)	(13,996)	(36,409)	(42,708)	(271,697)	(8,337)

### Exchange Rate Information

We conduct our business primarily in Taiwan and our revenues and expenses are primarily denominated in NT dollars. This annual report contains translations of NT dollar amounts into U.S. dollar amounts at specific rates solely for the convenience of the reader. The translations of NT dollar amounts into U.S. dollar amounts in this annual report are based on the noon buying rate in the City of New York for cable transfers of the NT dollar as certified for customs purposes by the Federal Reserve Bank of New York. Unless otherwise noted, all translations from NT dollar amounts to U.S. dollar amounts and from U.S. dollar amounts to NT dollar amounts in this annual report were made at a rate of NT\$32.590 to US\$1.00, the noon buying rate in effect as of December 31, 2006. The noon buying rate as of June 28, 2007 was NT\$32.82 to US\$1.00.

We make no representation that any NT dollar or U.S. dollar amounts could have been, or could be, converted into U.S. dollar or NT dollar amounts, as the case may be, at any particular rate, the rates stated below, or at all.

## [Table of Contents](#)

The following table sets forth information concerning exchange rates between NT dollars and U.S. dollars for the periods indicated. These rates are provided solely for your convenience and are not necessarily the exchange rates that we used in this annual report or will use in the preparation of our periodic reports or any other information to be provided to you. The source of these rates is the Federal Reserve Bank of New York.

	<b>Noon Buying Rate</b>	
	<b>NT\$ per US\$</b>	
	<b>High</b>	<b>Low</b>
December 2006	32.74	32.27
January 2007	32.99	32.38
February 2007	33.08	32.86
March 2007	33.13	32.88
April 2007	33.33	33.05
May 2007	33.41	32.97
June 2007 (through June 28)	33.18	32.74

The following table sets forth the average noon buying rates between NT dollars and U.S. dollars for each of the periods indicated, calculated by averaging the noon buying rates on the last day of each month of the periods shown.

	<b>Average Noon Buying Rate</b>
	<b>NT\$ Per US\$</b>
2002	34.53
2003	34.40
2004	33.27
2005	32.16
2006	32.49

## **Risk Factors**

### **Risks Related to Our Business**

***Because our operating results for any period could be adversely affected by a number of factors and may therefore fluctuate significantly, our annual and quarterly operating results are difficult to predict.***

Although we have been able to generate strong revenue and earnings growth and maintain relatively stable gross margins and operating margins, we cannot assure you that we will be able to maintain in the future growth rates and margins similar to those of past periods. A variety of factors may cause our growth rates and margins to decline, including:

- continuing downward pressure on the average selling prices of our products caused by intense competition in our industry and other reasons;
- decreases in demand for multimedia consumer electronics products, including mobile phones, into which our semiconductor solutions are directly or indirectly incorporated;
- our customers' sales outlook, purchasing patterns and inventory adjustments based on consumer demands and general economic conditions;
- the loss of one or more key customers or the significant reduction, postponement, rescheduling or cancellation of orders from these customers;
- changes in the seasonality of our sales, which generally has a tendency toward increased sales in the second half of each year;
- our ability to develop or acquire, introduce, market and transition to volume production new or enhanced products and technologies, and in a cost-effective and timely manner;



## [Table of Contents](#)

- changes in the relative sales mix of our products;
- the availability and pricing of third party semiconductor foundry, assembly and test capacity and raw materials, as well as other changes in our cost of finished goods;
- the availability, pricing and timeliness of delivery of other components and raw materials used in our customers' products;
- unpredictable volume and timing of customer orders, which are not fixed by contract but vary on a purchase order basis;
- superior product innovations by our competitors;
- the timing of new product announcements or introductions by us or by our competitors;
- competitors offering comparable products at cheaper prices;
- our ability to scale our operations in response to increasing demand by customers for our new or existing products;
- our ability to timely and accurately predict market requirements and evolving industry trends and to identify and capitalize upon opportunities in new markets; and
- the overall cyclical nature of, and changing economic and market conditions in, the semiconductor industry.

The result of these and other factors, as well as our recent rapid growth, makes it difficult for us to assess our future performance. Our quarterly sales and operating results are difficult to predict and have in the past, and will likely in the future, fluctuate from quarter to quarter. We could fail to achieve the operating targets that we have announced, such as revenue growth, gross margin, operating margins, and earnings per ADS. In addition, our operating results in the future may be below the expectations of public market analysts or investors, which would likely cause the market price of our ADSs to decline. Any variations in our period-to-period performance may also cause the market price of our ADSs to fluctuate. Accordingly, you should not rely on the results of any prior periods as a reliable indicator of our future operating performance.

***We depend on a small number of customers for a significant portion of our revenues and a loss of some of these customers would result in the loss of a significant portion of our revenues.***

We have derived a substantial portion of our past revenue from sales to a relatively small number of customers. As a result, the loss of any significant customer could materially and adversely affect our financial condition and results of operations. Sales to our five largest customers represented approximately 35%, 40% and 57% of our net revenue in 2006, 2005 and 2004, respectively. We only had one customer in 2006 and 2005 that accounted for 10% or more of our sales, and three customers in 2004 that accounted for 10% or more of our sales. The identities of our largest customers and their respective contributions to our net revenue have varied and will likely continue to vary from period to period.

Sales to our customers may be significantly higher if indirect sales are included with direct sales. In 2006, Samsung Electronics was our sixth largest customer and accounted for approximately 4% of our sales. In 2006, ATP Electronics and Barun Electronics were our second and seventh largest customers and accounted for approximately 9% and 4% of our sales, respectively. We believe a substantial portion of our sales to ATP Electronics and Barun Electronics are included in the products of Samsung Electronics and that such direct and indirect sales to Samsung Electronics amounted to between 13% and 15% of our net sales. We believe that if our sales to ATP Electronics and Barun Electronics were included in our sales to Samsung Electronics in 2005 and 2004, such direct and indirect sales to Samsung Electronics would amount to between 10% and 12% and 4% and 5% in the respective years. In 2006, 2005 and 2004, Lexar Media was our ninth, fourth and second largest customer and accounted for approximately 3%, 7% and 13% of our sales in the respective years. We believe a substantial portion of our sales to Power Digital Card and Macrotron Systems in 2006, 2005 and 2004 are included in Lexar Media's products and that such indirect and direct sales to Lexar Media amounted up to 8% of our net sales in 2006, up to 18% in 2005 and up to 35% of our net sales in 2004.

## [Table of Contents](#)

We expect that we will continue to depend on a relatively limited number of customers for a substantial portion of our net sales and our ability to maintain good relationships with these customers will be important to the ongoing success of our business. We cannot assure you that the revenue generated from these customers, individually or in the aggregate, will reach or exceed historical levels in any future period. Our failure to meet the demands of these customers could lead to a cancellation or reduction of business from these customers. In addition, loss, cancellation or reduction of business from, significant changes in scheduled deliveries to, or decreases in the prices of products sold to, any of these customers could significantly reduce our revenues and adversely affect our financial condition and operating results. Moreover, any difficulty in collecting outstanding amounts due from our customers particularly customers who place large orders, would harm our financial performance. In addition, if our relationships with our largest customers are disrupted for any reason, it could have a significant impact on our business.

***The acquisition of FCI could result in operating difficulties, loss of key personnel and other harmful consequences.***

We do not have significant experience acquiring companies. Although our previous business combination, which involved the acquisition of SMI USA by Feiya, has been successful, we cannot assure you that our acquisition of Future Communications IC, Inc., or FCI, on April 30, 2007 will be similarly successful. The process of integrating FCI may create unforeseen operating difficulties and expenditures. The areas where we may face risks include:

- implementation or remediation of controls, procedures and policies at FCI;
- diversion of management time and focus from operating our business to acquisition integration challenges;
- challenges associated with integrating employees from FCI into our organization such as different cultures and languages;
- integration of FCI's accounting, management information, human resource and other administrative systems; and
- other unique risks such as currency, economic, political and regulatory risks.

In addition, our success depends in part on the abilities and continued service of each of the current executives of FCI. We have service agreements in place with certain key FCI senior executives and have non-compete agreements with these senior FCI executives and other key FCI executives. Our executives at FCI along with other Silicon Motion executives and employees all benefit from long term employee retention programs which include participation in our Share-based Compensation Plans. If we are not able to retain the services of our FCI executives and incur the loss of their services, in the absence of adequate replacements, our ability to implement our business strategy for FCI and operate the business effectively would be harmed.

***We may not be able to sustain our current growth rates, and even if we do maintain them, we are susceptible to many challenges relating to our growth.***

We have experienced significant growth in the scope and complexity of our business. Our net sales grew from approximately NT\$915.1 million in 2003 to approximately NT\$2,166.7 million in 2004 to approximately NT\$2,686.5 million in 2005 and to approximately NT\$3,460.5 million (US\$106.2 million) in 2006. This growth has placed and will continue to place a strain on our management, personnel, systems and resources. If we are unable to manage our growth effectively, we may not be able to take advantage of market opportunities, develop new products, enhance our technological capabilities, satisfy customer requirements, execute on our business plan or respond to competitive pressures. In particular, the success of our goal to penetrate the MP3 market is highly contingent on the viability of our strategy and the success of our growth plans. To successfully manage our growth, we believe we must effectively:

- hire, train, integrate and manage additional qualified engineers, sales and marketing personnel and financial and information technology personnel;

## [Table of Contents](#)

- implement additional and improve existing administrative, financial and operations systems, procedures and controls;
- continue to enhance our manufacturing and customer resource management systems;
- continue to expand and upgrade our core semiconductor design and software development capabilities;
- manage multiple relationships with foundries, distributors, suppliers and certain other third parties; and
- manage our financial condition.

Our success also depends largely on our ability to anticipate and respond to expected changes in future demand for our products. In the event the timing of our expansion does not match market demand, our business strategy may need to be revised, and there could be delays in our roll-out of new products, which may adversely affect our growth and future prospects. If we over-expand and demand for our products does not increase as we may have projected, our financial results will be materially and adversely affected. However, if we do not expand, and demand for our products increases sharply, our business could be seriously harmed because we may not be as cost-effective as our competitors due to our inability to take advantage of increased economies of scale. In addition, we may not be able to satisfy the needs of our current customers or attract new customers, and we may lose credibility and our relationships with our customers may be negatively affected. Moreover, if we do not properly allocate our resources in line with future demand for particular products, we may miss changing market opportunities and our business and financial results could be materially and adversely affected. We cannot assure you that we will be able to successfully sustain our current growth rate or that we will be able to manage our growth in the future.

***Industry standards and demands in the multimedia consumer electronics market are continuously and rapidly evolving, and our success depends on our ability to anticipate and meet these changes and trends.***

In order to remain competitive in the future, we must ensure that our products meet continuously evolving industry standards and are compatible with rapidly changing customer requirements. If our products do not keep pace with evolving industry standards or if our products are not in compliance with prevailing industry standards for an extended period of time, we could be required to invest significant time, effort and funds to redesign our products to ensure compatibility with relevant standards. If we are slow to anticipate changing trends and respond to such changes in a timely manner, we could miss opportunities to capture potential customers and we could lose our existing market share or existing customers. Currently, our primary products are controllers used in flash memory storage devices. If new technologies for storing digital media are developed that compete with flash memory technology or render it obsolete and if we are not able to shift our product offerings accordingly, demand for our products would likely decline and our business would be materially and adversely affected.

In addition, we may not have sufficient financial resources to fund all of the required research to develop future innovations and meet changing industry standards. Moreover, even if we have adequate financial resources, our future innovations may be outpaced by competing innovations. As a result, we may lose customers and significant sales, and our business and operating results may be materially and adversely affected.

***If demand for our products declines in the major end markets that we serve, our selling prices and our overall sales will decrease.***

Demand for our products is affected by a number of factors, including the general demand for the products in the end markets that we serve and price attractiveness. A significant amount of our sales revenue is derived from customers who use our microcontrollers in removable and irremovable flash memory storage solutions used in communications, consumer electronics and computing devices, such as mobile phones, smart phones, digital cameras, PDAs, MP3 players and notebook and desktop PCs. Any significant decrease in the demand for these devices may decrease the demand for our semiconductor solutions and may result in a decrease in our revenues and earnings. A variety of factors, including economic, political and social instability, could contribute to a

## [Table of Contents](#)

slowdown in the demand for non-essential communications, consumer electronics and computing devices as consumers delay purchasing decisions or reduce their discretionary spending. In addition, the historical and continuing trend of declining average selling prices of communications, consumer electronics and computing devices places pricing pressure on our semiconductor solutions. As a result, we expect that the average selling prices for many of our semiconductor solutions will continue to decline over the long term. If we are not able to introduce higher margin products, reduce our manufacturing costs to offset expected declines in average selling prices or maintain a high capacity utilization rate, our gross margin will continue to decline, which could have a material and adverse effect on our financial condition and operating results.

***If the semiconductor industry suffers a shortage of flash memory, which is a key component in many of our customers' end products, our revenues could be adversely affected.***

In 2004 and 2005, some of our customers indicated that they were unable to acquire enough flash memory to meet all of the anticipated demand for their products. Several manufacturers of flash memory have increased manufacturing capacity for flash memory since then. However, we cannot assure you that there will continue to be enough additional capacity to satisfy worldwide demand for flash memory. According to IDC (Worldwide Flash Memory Card 2006-2010 Forecast, May 2006), the demand for flash memory cards is expected to rise rapidly through 2010. Because flash memory is a key component of most of the products manufactured by our customers, if any shortage in the supply of flash memory occurs and is not remedied, our customers may not be able to purchase enough flash memory to manufacture their products and may therefore purchase fewer semiconductor solutions from us than they would have otherwise purchased. Our ability to increase revenues and grow our profits could be materially and adversely affected as a result of any shortage or decrease in the supply of flash memory.

***A failure to accurately forecast customer demand may result in excess or insufficient inventory, which may increase our operating costs and harm our business.***

To ensure the availability of our products for our customers, in some cases we cause our manufacturers to begin manufacturing our products based on forecasts provided by these customers in advance of receiving purchase orders. However, these forecasts do not represent binding purchase commitments, and we do not recognize revenue from these products until they are shipped to the customer. As a result, we incur inventory and manufacturing costs in advance of anticipated revenue. Because demand for our products may not materialize, manufacturing based on forecasts subjects us to risks of high inventory carrying costs and increased obsolescence and may increase our costs. If we overestimate customer demand for our products or if purchase orders are cancelled or shipments delayed, we may end up with excess inventory that we cannot sell, which could have a material and adverse effect on our financial results. Conversely, if we underestimate demand, we may not have sufficient product inventory and may lose market share and damage customer relationships, which could also harm our business.

***The average selling prices of our products could decrease rapidly.***

We may experience period-to-period fluctuations in future operating results if our average selling prices decline. We may be forced to reduce the average unit price of our products in response to new product introductions by us or our competitors, competitive pricing pressures and other factors. The semiconductor market is extremely cost sensitive, which may result in declining average selling prices of the components comprising our products. We expect that these factors will create downward pressure on our average selling prices and operating results. To maintain acceptable operating results, we will need to develop and introduce new products and product enhancements on a timely basis and continue to reduce our costs. If we are unable to offset any reductions in our average selling prices by increasing our sales volumes or reducing corresponding production costs, or if we fail to develop and introduce new products and enhancements on a timely basis, our sales and operating results will be materially and adversely affected.

## [Table of Contents](#)

***We rely primarily on a small number of distributors to market and distribute certain of our products, and if we fail to maintain or expand these sales channels, our revenues would likely decline.***

Most of our embedded graphics processors and some of our other products are sold through independent distributors. Sales of these products to distributors generate a material amount of our revenues. Our business will depend on our ability to maintain and expand our relationships with distributors, develop additional channels for the distribution and sale of our products and effectively manage these relationships. Because not all of our distributors are required to make a specified minimum level of purchases from us, we cannot be certain that they will sell our products on a priority basis. As we continue to expand our indirect sales capabilities, we will need to manage the potential conflicts that may arise within our indirect sales force. We also rely on our distributors to accurately and timely report to us their sales of our products and to provide certain engineering support services to customers. Our inability to obtain accurate and timely reports and to successfully manage these relationships would have a material and adverse effect on our financial results.

***The loss of any of our key personnel or the failure to attract or retain specialized technical and management personnel could impair our ability to grow our business.***

We rely heavily on the services of our key employees, including Wallace C. Kou, our President and Chief Executive Officer. In addition, our engineers and other key technical personnel are a significant asset and are the source of our technological and product innovations. We believe our future success will depend upon our ability to retain these key employees and our ability to attract and retain other skilled managerial, engineering, technical and sales and marketing personnel. The competition for such personnel, particularly technical personnel, is intense in our industry. We may not be successful in attracting and retaining sufficient numbers of technical personnel to support our anticipated growth. These technical personnel are required to refine the existing hardware system and application programming interface and to introduce enhancements in future applications. Despite the incentives we provide, our current employees may not continue to work for us, and if additional personnel were required for our operations, we may not be able to obtain the services of additional personnel necessary for our growth. In addition, we do not maintain “key person” life insurance for any of our senior management or other key employees. The loss of any of our key employees or our inability to attract or retain qualified personnel, including engineers, could delay the development and introduction of, and have an adverse effect on our ability to sell, our products as well as our overall growth.

In addition, if any other members of our senior management or any of our other key personnel joins a competitor or forms a competing company, we may not be able to replace them easily and we may lose customers, business partners, key professionals and staff members. Substantially all of our senior executives and key personnel have entered into confidentiality and non-disclosure agreements. In the event of a dispute between any of our senior executives or key personnel and SMI Taiwan, we cannot assure you the extent, if any, to which these provisions may be enforceable in Taiwan due to uncertainties involving the Taiwan legal system.

***We may be unsuccessful in developing and selling new products or in penetrating new markets required to maintain or expand our business.***

Our revenue growth has been primarily from sales of our semiconductor solutions. Although we believe that our acquisition of FCI will enable us to offer more comprehensive solutions for mobile devices, our future success depends, in part, on our ability to develop successful new semiconductor solutions in a cost-effective and timely manner. We continually evaluate expenditures for planned product developments and choose among alternatives based upon our expectations of future market trends. The development of our semiconductor solutions is highly complex, and successful product development and market acceptance of our products depends on a number of factors, including:

- our accurate prediction of the changing requirements of our customers;
- our timely completion and introduction of new designs;

## [Table of Contents](#)

- the availability of third-party manufacturing, assembly and test capacity;
- the ability of our foundries to achieve high manufacturing yields for our products;
- our ability to transition to smaller manufacturing process geometries;
- the quality, price, performance, power efficiency and size of our products and those of our competitors;
- our management of our indirect sales channels;
- our customer service capabilities and responsiveness;
- the success of our relationships with existing and potential customers; and
- changes in industry standards.

We cannot assure you that we will be able to develop and introduce new or improved products in a timely and cost-effective manner, that the products we introduce will generate significant revenues or that we will be able to accurately anticipate or respond to future market trends.

***We may not be able to deliver our products on a timely basis if our relationships with our suppliers, our semiconductor foundries or our assembly and test subcontractors are disrupted or terminated.***

We do not own or operate a semiconductor fabrication facility. Instead, we rely on third parties to manufacture our semiconductors. Three outside foundries, UMC, in Taiwan, SMIC, in China, and STMicroelectronics in Europe currently manufacture the majority of our semiconductors. As a result, we face several significant risks, including higher wafer prices, lack of manufacturing capacity, quality assurance, manufacturing yields and production costs, limited control over delivery schedules and product quality, increased exposure to potential misappropriation of our intellectual property, labor shortages or strikes and actions taken by third party contractors that breach our agreements.

The ability of each foundry to provide us with semiconductors is limited by its available capacity. We do not have long-term agreements with any of these foundries and we place orders on a purchase order basis. We place our orders based on our customers' purchase orders and sales forecasts. However, the foundries can allocate capacity to the production of the products of their other customers and reduce deliveries to our manufacturing logistics partners on short notice or increase the price they charge us. It is possible that other foundry customers that are larger and better financed than we are, or have long-term agreements with these foundries, may induce these foundries to reallocate capacity to them. Any reallocation could impair our ability to secure the supply of semiconductors that we need for our products. In addition, interruptions to the wafer manufacturing processes caused by a natural disaster or human error could result in partial or complete disruption in supply until we are able to shift manufacturing to another fabrication facility. It may not be possible to obtain sufficient capacity or comparable production costs at another foundry. Migrating our design methodology to a new third-party foundry could involve increased costs, resources and development time comparable to a new product development effort. Any reduction in the supply of semiconductors for our products could significantly delay our ability to ship our products and potentially have negative effects on our relationships with existing customers and our results of operations. In addition, if our subcontractors terminate their relationships with us, we would be required to qualify new subcontractors, which could take as long as six months, resulting in unforeseen operations problems, and our operating results may be materially and adversely affected.

***If the foundries that provide us with the products for our operations do not achieve satisfactory yield or quality, or if the assembly and testing services fail us in the quality of their output, then our revenue, operating results and customer relationships will be affected.***

The manufacture of semiconductors is a highly complex process. Minor deviations in the manufacturing process can cause substantial decreases in yield. In some situations, such deviations may cause production to be suspended. The foundries that manufacture our semiconductors have from time to time experienced lower than

## [Table of Contents](#)

anticipated manufacturing yields, including yields for our semiconductors, typically during the production of new products or architectures or during the installation and start-up and ramp-up of new process technologies or equipment. If the foundries that manufacture our semiconductors do not achieve planned yields, our product costs could increase, and product availability would decrease.

After the wafer fabrication processes, our wafers are shipped to our assembly and testing subcontractors. We have a system to maximize consistent product quality, reliability and yield which involve our quality assurance team working closely with pertinent subcontractors in the various phases of the assembly and testing processes. We also emphasize a strong supplier quality management practice through which our quality assurance team pre-qualifies our manufacturing suppliers and subcontractors. However, despite our efforts to strengthen supplier quality management, if our foundries fail to deliver fabricated silicon wafers of satisfactory quality in the volume and at the price we require, or if our assembly and testing subcontractors fail to efficiently and accurately assemble and test our products, we will be unable to meet our customers' demand for our products or to sell those products at an acceptable profit margin, which would have a material and adverse effect on our sales and margins and damage our customer relationships.

***Failure to protect our proprietary technologies or maintain the right to certain technologies may negatively affect our ability to compete.***

We believe that the protection of our intellectual property rights will continue to be important to the success of our business. We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We also enter into confidentiality or license agreements with our employees, business partners and other third parties, and have implemented procedures to control access to and distribution of our documentation and other proprietary information. Despite these efforts, we cannot assure you that these measures will provide meaningful protection of our intellectual property rights. Further, these agreements do not prevent others from independently developing technologies that are equivalent to or superior to our technology. In addition, unauthorized parties may attempt to copy or otherwise obtain and use our proprietary technology. Monitoring unauthorized use of our technology is difficult, and we cannot be certain that the steps we have taken will prevent unauthorized use of our technology, particularly in foreign countries, such as China, where the laws may not protect our proprietary rights as fully as do the laws of the United States. In addition, if the foundries that manufacture our semiconductors lose control of our intellectual property, it would be more difficult for us to take remedial measures because our foundries are located in countries that do not have the same protection for intellectual property that is provided in the United States. Also, some of our contracts, including license agreements, are subject to termination upon certain types of change-of-control transactions.

We currently have more than 60 patents. We also have 78 patent applications pending in five countries. We cannot be certain that patents will be issued as a result of our pending applications nor can we be certain that any issued patents would protect or benefit us or give us adequate protection from competing products. For example, issued patents may be circumvented or challenged and declared invalid or unenforceable or provide only limited protection for our technologies. We also cannot be certain that others will not design around our patented technology, independently develop our unpatented proprietary technology or develop effective competing technologies on their own.

***Failure to successfully defend against intellectual property lawsuits brought against us may adversely affect our business.***

As technology is an integral part of our design and product, we have, in the past, received communications alleging that our products infringe or misappropriate certain intellectual property rights held by others, and may continue to receive such communications in the future. We recently agreed with O2Micro International Limited to settle several intellectual property disputes and both parties have started to withdraw their claims and applications. See "Our Business — Legal Proceedings." If any third party were to make valid intellectual property infringement or misappropriation claims against us, we may be required to:

- discontinue using disputed manufacturing process technologies;

## [Table of Contents](#)

- stop selling products that contain allegedly infringing technology;
- pay substantial monetary damages;
- seek to develop non-infringing technologies, which may not be feasible; or
- seek to acquire licenses to the infringed technology, which may not be available on commercially reasonable terms, if at all.

If our products are found to infringe or misappropriate third-party intellectual property rights, we may be subject to significant liabilities and be required to change our manufacturing processes or products. This could restrict us from making, using, selling or exporting some of our products, which could in turn materially and adversely affect our business and financial condition. Our failure to develop non-infringing technologies or license intellectual property rights in a timely and cost-effective manner could materially and adversely affect our business and financial condition. In addition, any litigation, whether to enforce our patents or other intellectual property rights or to defend ourselves against claims that we have infringed the intellectual property rights of others, could, regardless of the ultimate outcome, materially and adversely affect our operating results by requiring us to incur significant legal expenses and diverting the resources of the company and the attention of management.

***Failure to achieve and maintain technological leadership in our various multimedia consumer electronics markets could erode our competitiveness and cause our profits to decrease.***

The consumer electronics market and the semiconductor components used in such market are constantly changing with increased demand for improved features such as low power or smaller size. If we do not anticipate these changes in technologies and rapidly develop and introduce new and innovative technologies, we may not be able to provide advanced semiconductor solutions on competitive terms. If we are unable to maintain the ability to provide advanced semiconductor solutions on competitive terms, some of our customers may buy semiconductor solutions from our competitors instead of us. To be competitive, we must anticipate the needs of the market and successfully develop and introduce innovative new products in a timely fashion. We cannot assure you that we will be able to successfully complete the design of our new products, have these products manufactured at acceptable manufacturing yields, or obtain significant purchase orders for these products. Furthermore, if our future innovations are ahead of the then-current technological standards in our industry, customers may be unwilling to purchase our platforms until the multimedia consumer electronics market is ready to accept them. The introduction of new products may adversely affect sales of existing products and contribute to fluctuations in our operating results from quarter to quarter. Our introduction of new products also requires that we carefully manage our inventory to avoid inventory surplus and obsolescence. Our failure to do so could have a material and adverse effect on our operating results. Furthermore, failure to achieve advances in technology or processes or to obtain access to advanced technologies or processes developed by others could erode our competitive position.

Development of new platforms and products may require us to obtain rights to use intellectual property that we currently do not have. If we are unable to obtain or license the necessary intellectual property on reasonable terms or at all, our product development may be delayed, the gross margins on our planned products may be lower than anticipated and our business and operating results would be materially and adversely affected.

***Because the markets in which we compete are highly competitive and many of our competitors have greater resources than we have, we cannot be certain that our products will compete favorably in the market place.***

We face competition from a large number of competitors in each of our targeted areas. We currently compete with other companies that produce flash storage controllers, such as Alcor Micro, Chipsbank, Genesys, Incomm, Phison, Samsung, Skymedi, and USBest. We may also face competition from some of our customers who may develop products or technologies internally that compete with our solution. For multimedia SoC



## [Table of Contents](#)

products, the companies with whom we compete include Actions, ALi, AMD, NVIDIA, Rockchip, SigmaTel, and Vimicro. For mobile communications products, the companies with whom we compete include Analog Devices, Infineon, Qualcomm, NXP, RFMD and Skyworks. We expect to face increased competition in the future from our current and potential competitors. In addition, some of our customers have developed products and technologies that could replace their need for our products or otherwise reduce their demand for our products.

Many of our current and potential competitors have longer operating histories, greater name recognition, access to larger customer bases and significantly greater financial, sales and marketing, manufacturing, distribution, technical and other resources than we have. As a result, they may be able to respond more quickly to changing customer demands or to devote greater resources to the development, promotion and sales of their products than we can. Our current and potential competitors may develop and introduce new products that will be priced lower, provide superior performance or achieve greater market acceptance than our products. In addition, in the event of a manufacturing capacity shortage, these competitors may be able to obtain capacity when we are unable to do so.

The multimedia consumer electronics market, which is a principal end market for our products, has historically been subject to intense price competition. In many cases, low-cost, high-volume producers have entered the markets and driven down profit margins. If a low-cost, high-volume producer should develop products that compete with our products, our sales and profit margins would suffer.

### ***Fluctuations in exchange rates could result in foreign exchange losses.***

Our reporting currency is the NT dollar. However, a significant portion of our operating expenses is denominated in currencies other than the NT dollar, primarily U.S. dollars, but also, to a lesser extent, Japanese Yen, Renminbi, Euros, and South Korean Won. As a result, appreciation or depreciation of other currencies in relation to the NT dollar could result in material transaction or translation gains or losses that could adversely affect, or cause fluctuations in, our results of operations. We do not currently engage in currency hedging activities.

### ***Our products must meet exacting specifications and undetected defects and failures may occur, which may cause customers to return or stop buying our products and may expose us to product liability risk and risks of indemnification against defects in our products.***

Our products are complex and may contain undetected hardware or software defects or failures, especially when first introduced or when new versions are released. These errors could cause us to incur significant re-engineering costs, divert the attention of our engineering personnel from product development efforts and materially affect our customer relations and business reputation. If we deliver products with errors or defects, our credibility and the market acceptance and sales of our products could be harmed. Defects could also lead to liability for defective products as a result of lawsuits against us or against our customers. We have agreed to indemnify some of our customers in some circumstances against liability from defects in our products. A successful product liability claim could require us to make significant damage payments.

### ***Our intellectual property indemnification practices may adversely impact our business.***

We may be required to indemnify our customers and our third-party intellectual property providers for certain costs and damages of intellectual property infringement in circumstances where our products are a factor in creating the customer's or these third-party providers' infringement exposure. This practice may subject us to significant indemnification claims by our customers and our third-party providers. In some instances, our products are designed for use in devices manufactured by our customers that comply with international standards, such as the MP3 compression standard. These international standards are often covered by patent rights held by third parties, which may include our competitors. The combined costs of identifying and obtaining licenses from

## [Table of Contents](#)

all holders of patent rights essential to such international standards could be high and could reduce our profitability or increase our losses. The cost of not obtaining these licenses could also be high if a holder of the patent rights brings a claim for patent infringement. In the contracts under which we distribute semiconductor products, we generally have agreed to indemnify our customers against losses arising out of claims of unauthorized use of intellectual property. In some of our licensing agreements, we have agreed to indemnify the licensor against losses arising out of or related to our conduct or services. We cannot assure you that additional claims for indemnification will not be made or that these claims would not have a material and adverse effect on our business, operating results or financial condition.

***Major earthquakes, fires or other natural disasters and resulting systems outages may cause us significant losses.***

Our principal executive offices and a significant part of our operations are based in Taiwan. Many of our suppliers, providers of semiconductor manufacturing services for us, including semiconductor foundries and primary subcontractors for the assembly and testing of our products are located in Taiwan.

Taiwan is particularly susceptible to earthquakes. For example, in September 1999, Taiwan experienced a severe earthquake that caused significant property damage and loss of life, particularly in the central part of Taiwan. Although earthquakes and other natural disasters in Taiwan have not caused serious damages to us, if we, our suppliers, providers of semiconductor manufacturing services and primary subcontractors are affected by an earthquake or other natural disasters, such as typhoons, our production schedule could be interrupted or delayed. As a result, a major earthquake, natural disaster or other disruptive events in Taiwan could severely disrupt the normal operation of business and have a material and adverse effect on our financial condition and operating results.

The manufacturers of our semiconductors use highly flammable materials such as alcohol, acetone, photo resistance, AsH<sub>3</sub> and PH<sub>3</sub>, in the manufacturing processes and are therefore subject to the risk of loss arising from explosion and fire. The risk of explosion and fire associated with these materials cannot be completely eliminated. Semiconductor companies experience explosion and fire damage from time to time. If any of their fabs or assembly facilities were to be damaged or cease operations as a result of an explosion or fire, it could reduce their manufacturing capacity. Such a reduction in the manufacturing capacity of our manufacturers could disrupt the production schedule of our products thereby causing us to miss orders from our customers, which will in turn have a material and adverse effect on our business and operating results.

***The recurrence of a severe acute respiratory syndrome outbreak or an outbreak of avian influenza or other outbreaks could materially and adversely affect our operating results and financial conditions.***

In early 2003, China and certain other areas in Asia experienced an outbreak of severe acute respiratory syndrome, or SARS. In addition, in the spring of 2004, China had several reported cases of deaths caused by SARS. A general downturn in most Asian economies accompanied the outbreak.

In 2003, an outbreak of avian influenza affected bird and poultry populations in countries throughout Southeast Asia and other parts of Asia, including China, Hong Kong and Japan. Avian influenza resulted in human deaths in Vietnam and Thailand. Any recurrence of SARS, avian influenza or other outbreak may have a negative effect on our operations. Our operations may be impacted by a number of health-related factors, including, among other things, quarantines or closure of our offices, the sickness or death of our key officers and employees and a general slowdown in the economies of China, Hong Kong and Taiwan, among other countries where we have operations.

***Our inability to achieve and maintain effective internal control over financial reporting could negatively impact our business, our results of operations and the market price of our ADSs.***

SEC rules implementing Section 404 of the Sarbanes-Oxley Act of 2002 require us to include in our Annual Reports on Form 20-F a report by our management on our internal control over financial reporting that contains

## [Table of Contents](#)

our management's assessment of the effectiveness of our internal control over financial reporting. In addition, beginning next year, our independent auditor must attest to and report on management's assessment. We expect to incur additional costs and use significant management and other resources in an effort to comply with Section 404 of the Sarbanes-Oxley Act and other requirements associated with our public company reporting requirements that we did not incur as a private company.

Our management could potentially conclude that our internal controls over financial reporting are not effective. Even if our management concludes that our internal controls are effective, our independent auditor may disagree with management's assessment. Alternatively, our independent auditor may decline to attest to our management's assessment or may issue an adverse opinion if its interpretation of the requirements differs from our or it is otherwise dissatisfied with our internal control over financial reporting or the level at which our internal control over financial reporting is documented, designed, operated or reviewed. Any of these possible scenarios could cause investors to lose confidence in the reliability of our consolidated financial statements, which could result in a decline in the market price of our ADSs. Moreover, if we fail to maintain acceptable internal control over financial reporting, fail to implement required new or improved controls, or experience difficulties in their implementation, our business and operating results could suffer, we could fail to meet our reporting obligations, and the market price of ADSs could decline as a result.

***Our stock price has been, and may continue to be, volatile, which could result in investors losing all or part of their investments.***

The market price of our ADSs has fluctuated significantly in the past and may continue to fluctuate in the future. We believe that such fluctuations will continue as a result of many factors, including future announcements concerning us, our competitors or the semiconductor industry in general or principal customers regarding financial results or expectations, technological innovations, industry supply dynamics, new product introductions, governmental regulations, the commencement or results of litigation or changes in earnings estimates by analysts. In addition, in recent years the stock market has experienced significant price and volume fluctuations and the market prices of the securities of high technology and semiconductor companies have been especially volatile, often for reasons outside the control of the particular companies. These fluctuations as well as general economic, political and market conditions may have an adverse affect on the market price of our ADSs.

***We may make acquisitions that are dilutive to existing stockholders, result in unanticipated accounting charges or otherwise adversely affect our results of operations, and result in difficulties in assimilating and integrating the operations, personnel, technologies, products and information systems of acquired companies or businesses.***

We continually evaluate and explore strategic opportunities as they arise, including business combinations and capital investments. If we issue equity securities in connection with an acquisition, the issuance may be dilutive to our existing stockholders. Alternatively, acquisitions made entirely or partially for cash would reduce our cash reserves.

Acquisitions may require significant capital infusions, typically entail many risks and could result in difficulties in assimilating and integrating the operations, personnel, technologies, products and information systems of acquired companies. In order to realize the intended benefits of acquisitions, we will have to successfully integrate and retain key personnel. We may experience delays in the timing and successful integration of acquired technologies and product development through volume production, unanticipated costs and expenditures, changing relationships with customers, suppliers and strategic partners, or contractual, intellectual property or employment issues. In addition, key personnel of an acquired company may decide not to work for us. The acquisition of another company or its products and technologies may also result in our entering into a geographic or business market in which we have little or no prior experience. These challenges could disrupt our ongoing business, distract our management and employees, harm our reputation, subject us to an increased risk of intellectual property and other litigation and increase our expenses. These challenges are

## [Table of Contents](#)

magnified as the size of the acquisition increases, and we cannot assure you that we will realize the intended benefits of any acquisition. Acquisitions may require large one-time charges and can result in increased debt or contingent liabilities, adverse tax consequences, substantial depreciation or deferred compensation charges, the amortization of identifiable purchased intangible assets or impairment of goodwill, any of which could have a material adverse effect on our business, financial condition or results of operations.

Mergers and acquisitions of high-technology companies are inherently risky and subject to many factors outside of our control, and no assurance can be given that our previous or future acquisitions will be successful and will not materially adversely affect our business, operating results, or financial condition. Failure to manage and successfully integrate acquisitions could materially harm our business and operating results. Even when an acquired company has already developed and marketed products, there can be no assurance that such products will be successful after the closing, will not cannibalize sales of our existing products, that product enhancements will be made in a timely fashion or that pre-acquisition due diligence will have identified all possible issues that might arise with respect to such company.

### **Political, Regulatory and Economic Risks**

***We face substantial political risks associated with doing business in Taiwan because of the tense political relationship between Taiwan and the People's Republic of China.***

While we also, through our acquisition of FCI, maintain substantive operations in Korea, our principal executive offices and a majority of our employees and a significant amount of our research and development and operations are based in Taiwan. In addition, two of our primary third party manufacturers, UMC and SMIC, are located in Taiwan and China, respectively. Accordingly, our business and results of operations and the market price of our ADSs may be affected by changes in Taiwan governmental policies, taxation, inflation or interest rates and by social instability and diplomatic and social developments in or affecting Taiwan that are outside of our control. Taiwan has a unique international political status. China does not recognize the sovereignty of Taiwan. Although there have been significant economic and cultural ties between the Taiwan and China in recent years, the political relations have often been strained. The government of China has indicated that it may use military force to gain control over Taiwan, particularly under what it considers as highly provocative circumstances, such as a declaration of independence by Taiwan or the refusal by Taiwan to accept China's stated "one China" policy. On March 14, 2005, the National Peoples' Congress of China passed what is widely referred to as the "anti-secession" law, a law authorizing the Chinese military to attack in order to block moves by Taiwan toward formal independence. Past developments in relations between Taiwan and China have on occasion depressed the market prices of the securities of Taiwanese companies. Relations between Taiwan and China and other factors affecting military, political or economic conditions in Taiwan could have a material adverse effect on our financial condition and results of operations, as well as the market price of our ADSs.

The relations between Taiwan and China and other factors affecting military, political or economic conditions in Taiwan could also have a material and adverse effect on the financial condition of two of our primary foundries that manufacture most of our semiconductors. One of the foundries, UMC, is located in Taiwan, and the other, SMIC, is located in China. Such relations between Taiwan and China and other factors could also have a material and adverse effect on the financial condition of SPIL and King Yuan Electronics, two of our primary subcontractors for the assembly and testing of our products, which are also located in Taiwan. In addition, any expansion or development of our research and development team in China could be restricted or jeopardized, and our sales and marketing performance may be affected.

***Our business depends on the support of the Taiwan government, and a decrease in this support may increase our tax liabilities and decrease our net income.***

The Taiwan government has been very supportive of technology companies such as ours. In particular, we, like many Taiwanese technology companies, have benefited from tax incentives provided by the Taiwan

## [Table of Contents](#)

government. For example, under the Statute for Upgrading Industries of Taiwan, we are granted tax credits by the Taiwan Ministry of Finance at rates set at certain percentages of the amounts utilized in qualifying research and development costs and in qualifying employee training expenses. If such tax credits cannot be utilized in the fiscal year in which the relevant costs or expenses were incurred, they may be carried forward for up to the next four years. In addition, Taiwan law offers preferential tax treatments to industries that are encouraged by the Taiwan government. These preferential tax treatments include 5-year tax exemptions for income attributable to expanded production capacity or newly developed technologies funded in whole or in part by proceeds from initial capital investments made by our shareholders, or subsequent capital increases, or capitalization of our retained earnings. Such tax exemptions may be available either to the shareholders of a company, or, if the shareholders so determine, to the company itself. SMI Taiwan has filed three applications for such tax exemptions as SMI Taiwan had used the proceeds of the new share offerings received in 2002, 2003 and 2004 to fund eligible research and development projects. In the first quarter of 2005, SMI Taiwan received certain requisite consents or approvals for tax exemptions. See “Management’s Discussion and Analysis of Financial Conditions and Results of Operations — Principal Factors Affecting Our Results of Operations — Provision for income taxes” and note 13 to our consolidated financial statements for a more detailed description of our ability to enjoy these preferential tax treatments. If any of our tax credits or our ability to take advantage of these preferential tax treatments are curtailed or eliminated, our net income may decrease materially.

*If we are unable to satisfy the conditions set by the Investment Commission of the Taiwan Ministry of Economic Affairs, or the IC, the effectiveness of the share exchange leading to the establishment of our current corporate structure could be challenged by the ROC government authorities.*

Our current corporate structure is established as a result of a share exchange between us and the shareholders of SMI Taiwan. Approval from the IC was sought and successfully granted for the share exchange. However the IC granted the approval on condition that SMI Taiwan must firstly, apply for at least five patents in each of 2005, 2006 and 2007, secondly, employ between 15 to 20 research and development engineers in each of 2005, 2006, and 2007, and finally, maintain research and development expenditures in the amount of at least NT\$100 million (US\$3.0 million) in each of 2005, 2006, and 2007. We are required to submit to the IC SMI Taiwan’s annual financial statements audited by a certified public accountant and other relevant supporting documents in connection with the implementation of those three conditions within four months after the end of each of 2005, 2006 and 2007. To the extent that we are unable to satisfy any of those three conditions, the IC may revoke our rights of repatriation of profits to be distributed by SMI Taiwan or rescind its approval of the share exchange. This would have an adverse effect on our corporate structure and consequently, materially and adversely affect our ability to conduct our business.

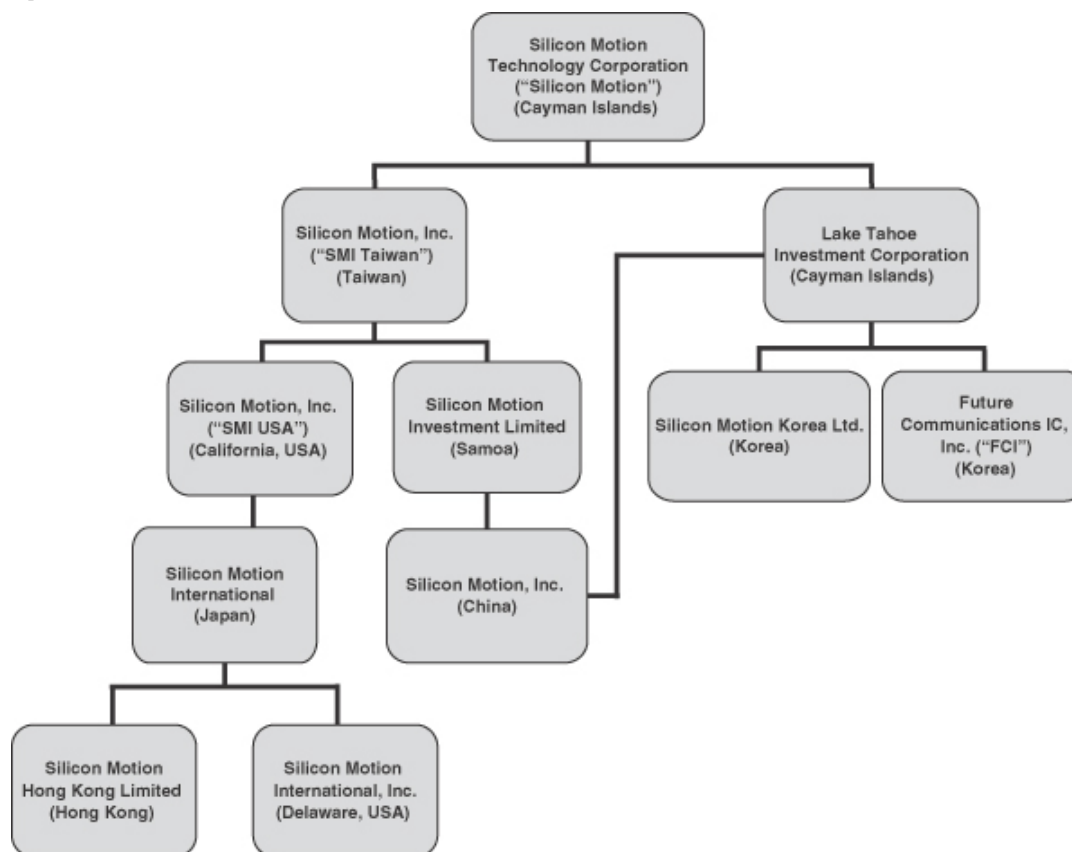
#### **ITEM 4. INFORMATION ON THE COMPANY**

##### **History and Development of the Company**

Silicon Motion Technology Corporation (“Silicon Motion”) was incorporated in the Cayman Islands in January 2005 and acquired Silicon Motion, Inc., a Taiwan corporation (“SMI Taiwan”) in April 2005. Originally SMI Taiwan was known as Feiya Technology Corporation (“Feiya”), a Taiwan corporation which was incorporated in April 1997 but had changed its name to SMI Taiwan after acquiring in August 2002 Silicon Motion, Inc., a California corporation (“SMI USA”), which was incorporated in November 1995. Feiya was originally a flash memory products company and SMI USA a graphics processor company. In April 2007, we acquired Future Communications IC, Inc. (“FCI”), a leading designer of RF ICs for mobile TV and wireless communications based in South Korea.

Our principal executive offices are located at No. 20-1, Taiyuan St., Jhubei City, Hsinchu County 302, Taiwan. The address of our United States subsidiary, SMI USA is 1591 McCarthy Blvd., Milpitas, CA 95035. Our ADSs have been listed and traded on the Nasdaq National Market since June 2005.

Our corporate group chart is set out below.



**Overview**

We are a fabless semiconductor company that designs, develops and markets universally compatible, high-performance, low-power semiconductor solutions for the multimedia consumer electronics market. We have three major product lines: our mobile storage business, multimedia SoC business, and mobile communications business. Our mobile storage business is our significantly larger business and is composed of microcontrollers, also commonly known as controllers, used in NAND flash memory storage products such as flash memory cards, USB flash drives and card readers. These flash memory storage products are widely used by consumers to store data on multimedia consumer electronics devices such as mobile phones, digital still cameras, personal digital assistants, personal navigation devices and personal multimedia players, and notebook and desktop personal computers. Our multimedia SoC business is composed of products that support MP3 and personal multimedia players, PC cameras and embedded graphics applications. Our mobile communications business is composed of mobile TV tuners, CDMA RF ICs and electronics toll collection RF ICs, which became our new product line as a result of our recent acquisition of FCI.

We sell our semiconductor solutions to leading original equipment manufacturers (“OEMs”) and original design manufacturers (“ODMs”) worldwide. We provide our high performance flash memory storage controller to companies such as Lexar Media, Samsung, Sony, STMicroelectronics, and Transcend. We are a leading supplier of controllers used in flash memory cards sold bundled with mobile phones manufactured by the handset

## [Table of Contents](#)

industry's leading OEMs. Our multimedia SoCs are important components of MP3 and embedded graphics applications that are sold by companies such as Advantech, Fuji Xerox, GE, Intel, Kontron, Mattel, Panasonic, Philips, Sharp, Siemens, Sony, Thomson and Toshiba. We provide our innovative mobile communications ICs to LG Electronics, Pantech & Curitel, Samsung and other companies. We sell our products through our direct sales force and distributors in Canada, China, Europe, Japan, Korea, Singapore, Taiwan and the United States.

We have experienced rapid growth in our net sales. Our net sales grew from approximately NT\$915.1 million in 2003 to approximately NT\$2,166.7 million in 2004 to approximately NT\$2,686.5 million in 2005 to approximately NT\$3,460.5 million (US\$106 million) in 2006, representing a compound annual growth rate, or CAGR of approximately 56%.

### **Recent Acquisition of Future Communications IC, Inc.**

In April 2007, we acquired Future Communications IC, Inc. FCI is a leading designer of RF ICs for mobile TV and wireless communications based in Seoul, South Korea. The final purchase price for the transaction was approximately US\$50 million in cash and US\$40 million in our ordinary shares and options to purchase our ordinary shares. We have agreed to pay FCI shareholders up to an additional \$12 million in cash under certain circumstances. The first condition is that FCI achieves, for its fiscal year 2007 ending December 31, 2007, a \$33 million revenue target and a 53% product margin target. The second condition relates to the performance of our stock. If both the FCI revenue and product margin targets are reached, we have agreed to pay to FCI shareholders in cash the difference between US\$12 million and 90% of the appreciation of our ADSs over an agreed period of time in the stock portion of the consideration received as part of this transaction. Before the inclusion of FCI acquisition-related charges, management expects that the transaction will be slightly accretive to earnings in 2007 and meaningfully accretive in 2008 and beyond.

### **Industry Background**

The convergence of consumer electronics, communications, and computing devices has been accelerating at a faster rate in recent years as advances in technology enable different categories of electronic devices to offer similar functionalities, which often involve the processing, storage, and transfer of digital multimedia content. Mobile phones for example have been transformed into multimedia consumer electronics devices with camera, video recorder, music player, e-mail, internet access, television, and other functions, because mobile phones have increasingly sophisticated multimedia applications processing, data storage, and data transfer capabilities. Personal computers have also been transformed into multimedia consumer electronics devices by multimedia data processing, storage, and transfer technologies that include wireless connectivity, internet telephony, video telephony, and more advanced video and audio capabilities. Several important semiconductor technology developments have led to the significant improvement by electronics devices to process, store, and transfer digital multimedia content and these include the development of NAND flash as a widely used data storage medium, various high-performance multimedia application processors and advanced communication-related RF ICs.

Some of the key factors that are currently driving digital media semiconductor development include:

*Proliferation of digital media content.* Advances in digital technology have enabled audio, photo and video content to be digitized, transmitted, stored and catalogued. As the accessibility of digital media content continues to proliferate, demand has increased for a range of new digital consumer devices such as mobile phones with multimedia features, MP3 and other personal multimedia players, PC cameras, notebook PCs, and car navigation systems. Due to the proliferation of these devices, consumers will demand the ability to create, store, exchange and play back more digital media content than ever before. Two of the leading types of mobile storage of digital media content are flash memory cards and USB flash drives.

*Greater storage capacity and advances in storage technologies.* As technology advances, more and more memory-intensive applications have been developed to cater to consumer demands. For example, the resolution of consumer digital still cameras has increased from approximately one megapixel to eight megapixels or greater.

## [Table of Contents](#)

The average resolution of camera phones has also been increasing. Correspondingly, greater capacity is required to store the increasingly larger size of digital photo collections, personal digital audio libraries and digital videos. Rapid increase in NAND flash storage capacity and performance and rapid reduction in cost of NAND flash have allowed memory card using NAND flash to become the predominant memory medium to store such increasing digital media content.

*Demand for greater mobility.* Consumers are increasingly using portable devices to compute and exchange data, enjoy music including radio, take pictures and video, watch television and communicate with each other. Developments in high-speed wireless transmission protocols, such as CDMA, WCDMA, DAB, DVB-H, T-DMB, and S-DMB facilitate the one-way or two-way sharing and exchange of content and depend on high sensitivity, low power, high performance, small size, and low cost RF ICs for the sending and receiving of data.

*Demand for smaller, lighter and more power-efficient electronic devices.* Consumers are increasingly demanding portable electronic devices that enable them to enjoy digital media, communicate, and compute independent of physical location. To respond to demand for smaller, lighter and more power-efficient portable electronic devices, manufacturers are increasingly seeking highly-integrated multimedia solutions, such as system on chip (“SoC”) for MP3 players, embedded graphics applications and PC cameras.

### **Our Markets and Products**

We design, develop and supply a portfolio of products targeted to multimedia consumer electronics applications. Our current product offerings are primarily targeted at three main markets: mobile storage, multimedia SoCs and mobile communications markets. The following is a brief description of each of our target markets.

#### **Mobile Storage Products**

We offer a broad range of controllers for NAND flash memory storage products, including flash memory cards, USB flash drives and card readers, and have recently began offering embedded controller solutions and controllers for solid state drives. Flash memory storage products are widely used by consumers to store data for multimedia consumer electronics devices such as mobile phones, digital still cameras, personal digital assistants, personal navigation devices, personal multimedia players, and notebook and desktop PCs. Flash memory cards and USB flash drives are two of the largest end applications for NAND flash. Our controllers are designed to be compatible with and the companion IC to the vast majority of NAND flash produced by companies such as Hynix, Intel, Micron, Samsung, STMicroelectronics and Toshiba. Because NAND flash from different manufacturers may be dissimilar in terms of IC packaging, input/output timing, command code and other factors, a controller plays an important role in ensuring NAND flash used in flash memory storage products are compatible with consumer electronics host devices. New NAND flash from different manufacturers or the same vendor may require updates to the firmware in the controller, extensive and thorough debugging and testing of the controller with the updated NAND flash driver and extensive and thorough compatibility testing of the NAND flash memory storage product.

Key functions of our flash memory card and USB flash drive controllers include:

- managing data input and output between the NAND flash in the flash memory storage product and the consumer electronics host device;
- ensuring that flash memory storage products which use our controllers are compatible with the widest possible universe of consumer electronics host devices;
- ensuring data reliability in NAND flash by detecting and correcting single bit errors in the NAND flash;
- on a larger scale, ensuring data integrity in a NAND flash by mapping bad blocks and preventing the bad blocks from being used for storing data;



## [Table of Contents](#)

- maximizing the life of a NAND flash with wear-leveling algorithms which spreads out the use of the memory array and equalizes the use of all the memory cells;
- enhancing the read and write performance of NAND flash by utilizing two-plane architecture, interleaving, or other technologies; and
- implementing security features to protect software code, personal data and multimedia digital rights.

*Flash memory card controllers.* NAND flash memory cards are non-volatile, solid state storage media that have become the predominate media for the storage of multimedia data used in mobile phones, digital still cameras and other portable consumer electronic devices because of their small and compact form factor, large storage capacity, low power consumption, high speed data transfer rate, and support of certain copyright protection technologies.

We believe we offer the broadest line of high-performance controllers for all major NAND flash memory card formats, including Compact Flash (“CF”), Memory Stick, MultiMedia Card (“MMC”), Secure Digital (“SD”) and xD-Picture Card (“xD”), as well as sub-types of these formats, such as SD card’s miniSD card and microSD card. We believe that our controllers are compatible with the majority of NAND flash currently being produced by different flash memory manufacturers, including small and big block Single-Level Cell (“SLC”) and Multi-Level Cell (“MLC”) NAND flash.

Our proprietary IC design methodology, strong firmware capability, proprietary assembly techniques and comprehensive testing procedures enable us to offer controllers that have significant competitive advantages with respect to compatibility, speed, connectivity and cost. Based on our proprietary QuickWrite technology, we believe our controllers outperform competing products on product benchmarking tests. Our FastMDC technology enables high performance flash memory access time and high reliability of data storage. Our flash memory controllers are also designed for very low stand-by power consumption, to withstand electro-static discharge and to allow flexible flash memory configuration through both hardware and firmware. Our flash memory controller ICs are manufactured using standard CMOS processes at 0.18 micron and 0.16 micron.

*USB flash drive controllers.* USB flash drives are NAND flash memory data storage devices integrated with a standard USB (“universal serial bus”) interface, commonly high speed USB 2.0. They are typically small, lightweight, removable and rewritable. USB flash drives are more compact, generally faster, have large capacity for data and are more robust and reliable than other types of portable storage devices such as hard disk drives and CD or DVD optical storage medium used with optical drives.

Our high performance USB flash drive controllers can support single and dual-channel SLC and MLC NAND flash configuration and are compatible with the majority of flash memory currently being produced by different flash memory manufacturers. They are designed for high data transfer rates, low power consumption, offer our customers an overall low cost solution with integrated voltage regulators and stand-by power components and support Master and Slave SPI (“Serial Peripheral Interface”) for applications such as a fingerprint sensor. Our controllers can support Microsoft Vista’s ReadyBoost, which increases a PC’s respond time by caching application data on a USB flash drive that supplements a PC’s RAM. Our ICs are manufactured using CMOS processes at 0.16 micron.

*Card reader controllers.* Because flash memory cards are widely used with a wide range of consumer, computing, and communications devices, including mobile phones, digital still cameras, desktop and notebook PCs, printers, and TVs, these devices require either external or internal card readers.

We believe that we are uniquely placed to supply controllers for card readers that can support the widest range of flash memory cards because we supply more flash memory card controllers and for a wider range of card formats using a wider range of NAND flash from different manufacturers than any of our competitors. Our card reader controllers are designed to support single or multiple card slots for all the popular card formats, such as CF, Memory Stick, MMC, SD and xD. Our card reader controllers can also assist host device OEMs in implementing certain security features.

## [Table of Contents](#)

*Other storage controllers.* In addition to controllers for flash memory cards, USB flash drives and card readers, we have recently developed and have shipped to customers embedded controller solutions and controllers for solid state drives. Our embedded controller solutions include controllers mounted on the printed circuit board of electronic devices, such as DVD players and flat panel TVs, used to control NAND flash also mounted on the printed circuit board of the device, as well as controllers contained in a single semiconductor package with one or more companion NAND flash dies. Our controllers for solid state drives have been developed for use in certain notebook PCs and camcorders and digital 35mm single lens reflex cameras that have replaced tape storage or hard disk drives with solid state drivers.

### **Multimedia SoCs**

We design and develop a wide range of multimedia SoCs for MP3 and personal multimedia players, embedded graphics applications and PC cameras. SoCs are integrated circuits that include a central processing unit, memory interfaces and other components and that address a range of end application requirements, including low power, high performance, low cost and high levels of system integration. Our SoCs are manufactured using standard CMOS processes.

*Personal media player SoCs.* Personal media players are battery-powered, flash memory-based portable devices that store and play digital media such as audio, photos and video. The market for personal compressed audio players, commonly referred to as MP3 players, has grown rapidly and is beginning to incorporate other functions, such as video and wireless connectivity. MP3 players have become one of the most popular consumer electronics devices and have largely replaced personal cassette players and other traditional audio players.

We focus on SoCs for personal media players that use NAND flash as the data storage medium, the principal type of medium for these devices, which have largely replaced hard disk drive as a storage medium except for the largest memory capacity devices. Our solutions are designed to enable personal media players to manage thousands of digital media files, the number of which is limited to a large extent only by the capacity of the NAND flash used in the device. Personal media player SoCs are integrated solutions based on two key technology building blocks, codecs for audio and other media and a NAND flash controller, which is a Silicon Motions core technology. The capabilities of a personal media player's NAND flash controller is an important factor because the cost of NAND flash is a very large percentage of a personal media player's bill of materials and the largest category of cost.

Our personal media player SoCs are high performance, low power single-chip solutions that feature MP3 and WMA audio and JPEG image decoders, a NAND flash controller, power management, supports Microsoft's Windows Media DRM and interfaces to an FM module, USB 2.0, flash memory card formats, such as SD and MMC, and color LCD. Our newer generation SoCs also feature a motion JPEG digital signal processor.

*Embedded graphics processors.* Graphics processors are commonly used by desktop and notebook PCs, game consoles, work stations and multimedia mobile phones to increase the speed and complexity of images that can be displayed on a monitor, TV or screen, as well as improve color definition and image resolution. Graphics processors are also used to control the displays of servers and a wide range of consumer and lifestyle, medical and industrial, office equipment, entertainment and other products.

Before we combined our business with Feiya in 2005, SMI USA was principally a graphics processor company. We are currently focused primarily on designing, developing and marketing high-performance, low-power SoCs which contain a graphics processor engine and embedded memory and are highly integrated and low cost, small chip size, easy to design-in by systems integrators, and fully supported and not end-of-life. The markets in which we compete include low-end servers, consumer and lifestyle products, medical and industrial applications, office equipment and non-game console entertainment devices. Our embedded graphics processors are generally used to render text, 2D graphics and graphical user interface (GUI) on displays.

## [Table of Contents](#)

Based on our DualMon technology, our display controllers can drive two separate displays using one controller. This saves on costs as well as board estate. Our ReduceOn® technology enables intelligent power management which algorithmically varies the clock and power to functional units based on system needs to significantly reduce average operating power usage. End-users can thus use the mobile devices for longer periods without a reduction in performance.

*Image processors.* With improvements in the bandwidth of broadband internet access and video telephony software, consumers are increasingly using desktop and notebook PCs equipped with webcams to conduct video telephony and conferences. An image processor is required to process and enhance the image captured by the CMOS image sensors located behind the lens of a webcam.

Our single chip image controller for USB 2.0 PC camera solutions supports CMOS image sensors of up to 2.0 megapixels. Our SoC integrates the color processor engine, JPEG compression, AC-Link/IIS audio interface and high-speed USB 2.0 device controller and also supports all legacy PC systems equipped with USB 1.1 host interfaces.

### **Mobile Communications**

Beginning in May 2007, we started offering semiconductor solutions for mobile TV, mobile telephony, and electronic toll collection systems. Our new mobile communications portfolio of products became a part of our company following the completion of our acquisition of FCI at the end of April 2007. The core technology of FCI is RF ICs for mobile communications, whether for receiving mobile TV signals on mobile phones, receiving and transmitting voice, video and data on mobile phones or receiving and transmitting data between automobiles and highway toll collection systems for the wireless collection of toll fees.

*Mobile TV tuners.* Our products include mobile TV tuners for mobile phones. Our tuners are designed for many mobile TV broadcast standards including S-DMB and T-DMB. Our solutions for DVB-H, ISDB-T, and StiMi are currently under development. Our tuners can also receive digital audio broadcast (DAB) signals. According to competitor product benchmarking, we believe our mobile TV are among the best in the market in terms of smallest chip size, lowest power consumption, lowest noise and high adjacent channel selectivity (ACS). We cooperate closely with many demodulator IC partners and sell our products in die form or in a SiP in combination with a demodulator die provided by our demodulator IC partner.

*CDMA RF ICs.* We offer CDMA transmitters, receivers, transceivers, low noise amplifiers (LNA) and power amplifiers (PA).

*Electronic toll collection system RF ICs.* We are the sole supplier of transceiver ICs for Korea's electronic toll collection system.

### **Our Customers**

We sell our semiconductor solutions to leading original equipment manufacturers, or OEMs, and original design manufacturers, or ODMs, worldwide. We provide our high performance flash memory storage controller to companies such as Lexar Media, Samsung, Sony, STMicroelectronics, and Transcend. We are a leading supplier of controllers used in flash memory cards sold bundled with mobile phones manufactured by the handset industry's leading OEMs. Our multimedia SoCs are important components of MP3 and embedded graphics applications that are sold by companies such as Advantech, Fuji Xerox, GE, Intel, Kontron, Mattel, Panasonic, Philips, Sharp, Siemens, Sony, Thomson and Toshiba. We provide our innovative mobile communications ICs to LG Electronics, Pantech & Curitel, Samsung and other companies.

Sales to our five largest customers represented approximately 35%, 40% and 57% of our net revenue in 2006, 2005 and 2004, respectively. We only had one customer in 2006 and 2005 that accounted for 10% or more

## [Table of Contents](#)

of our sales, and three customers in 2004 that accounted for 10% or more of our sales in 2004. The identities of our largest customers and their respective contributions to our net revenue have varied and will likely continue to vary from period to period.

Sales to our customers may be significantly higher if indirect sales are included with direct sales. In 2006, Samsung Electronics was our sixth largest customer and accounted for approximately 4% of our sales. In 2006, ATP Electronics and Barun Electronics were our second and seventh largest customers and accounted for approximately 9% and 4% of our sales, respectively. We believe a substantial portion of our sales to ATP Electronics and Barun Electronics are included in the products of Samsung Electronics and that such direct and indirect sales to Samsung Electronics amounted to between 13% and 15% of our net sales. We believe that if our sales to ATP Electronics and Barun Electronics were included in our sales to Samsung Electronics in 2005 and 2004, such direct and indirect sales to Samsung Electronics would amount to between 10% and 12% and 4% and 5% in the respective years. In 2006, 2005 and 2004, Lexar Media was our ninth, fourth and second largest customer and accounted for approximately 3%, 7% and 13% of our sales in the respective years. We believe a substantial portion of our sales to Power Digital Card and Macrotron Systems in 2006, 2005 and 2004 are included in Lexar Media's products and that such indirect and direct sales to Lexar Media amounted up to 8% of our net sales in 2006, up to 18% in 2005 and up to 35% of our net sales in 2004.

The majority of our customers purchase our products through purchase orders, as opposed to entering into long-term contracts with us. The price for our products is typically agreed upon at the time a purchase order is placed.

### **Sales and Marketing**

We market and sell our products worldwide through a combination of direct sales personnel and independent distributors. We have direct sales personnel in Taiwan and the United States. Our direct sales force is divided into two groups that focus on retail and OEM and ODM opportunities, respectively. Approximately 72% of our sales in 2006 were attributable to our direct sales force while the remainder was attributable to independent distributors. As of December 31, 2006, we had 84 persons on our sales and marketing team, including 43 in Taiwan and 7 in the United States, and 34 persons on our after-sales support team in China, Japan, Korea and Germany. We intend to increase our sales efforts in order to expand our OEM and ODM customer base.

Our marketing group focuses on our product strategy, product road map, new product introduction process, demand assessment and competitive analysis. Our marketing group is responsible for promoting our products and solutions by actively participating in industry tradeshows and technical conferences, and maintaining close contact with our existing customers to assess demand and keep current with industry trends. We seek to work with potential and existing customers early in their design process in order to best match our products to their needs. We also provide field application support and assistance to existing and potential customers in designing, testing and qualifying systems that incorporate our products.

We are also actively involved in both the MMCA and the SDCA, which enable us to keep abreast of the latest developments in the flash memory card industry and promote our brand name. Our marketing group works closely with our sales and research and development groups to align our product development road map with the interests of our customers, both existing and potential. Our marketing group also works with our sales team to identify new business opportunities.

### **Research and Development**

We devote a significant amount of resources in research and development to broadening and strengthening our portfolio of product offerings. Our engineering team has expertise in system architecture, IC design, digital and mixed-signal design and software engineering. As of June 20, 2007, we had 60 patents in China, Japan,

## [Table of Contents](#)

Taiwan, Korea, and the United States, with approximately 191 full-time engineers focused in our research and development efforts and technical services support. These included 29 engineers in application-specific integrated circuits, 28 in systems engineering, 53 in firmware, 6 in software, 32 in laboratory and 43 in digital signal processing, computer-aided design, place and route, applications engineering and product engineering. Our research and development expenses were approximately NT\$238.5 million, NT\$373.5 million and NT\$502.2 million (US\$15.4 million) for the years ended December 31, 2004, 2005 and 2006, respectively. Our products-focused engineering offices are located in Hsinchu and Taipei, Taiwan, Seoul, South Korea, Shanghai, China and Milpitas, California. Our research and development efforts in the United States are mostly focused on embedded graphics products, while our research and development efforts in Asia are focused on mobile storage and other products.

### **Manufacturing**

We design and develop our products and electronically transfer our proprietary designs to independent foundries for the manufacturing and processing of silicon wafers. Once the wafers are manufactured, they are then shipped to third-party assembly and testing subcontractors. Individual dies on each wafer are assembled into finished ICs and undergo several stages of testing before delivery to our customers. We also ship bare dies to our customers. We believe that our strategy of outsourcing wafer fabrication, packaging and testing enables us to benefit from the research and development efforts of leading manufacturers without the requirement to commit substantial capital investments. Our fabless business model also provides us with the flexibility to engage vendors who offer services that best complement our products and technologies.

*Wafer fabrication.* UMC in Taiwan and SMIC in China are currently our primary foundries that manufacture most of our semiconductors. These foundries currently fabricate our devices using mature and stable CMOS process technology with line-widths of 0.16-, 0.18-, 0.25- and 0.35-micron. We also rely on STMicroelectronics as our foundry for mobile communications products using Bi-CMOS process technology. We regularly evaluate the benefits and feasibility, on a product-by-product basis, of migrating to more cost efficient manufacturing process technologies.

*Assembly and testing.* Following wafer fabrication, our wafers are shipped to our assembly and test subcontractors where they are probed, singulated into individual die, assembled into finished IC packages, and undergo the process of electronic final testing. In order to minimize cost and maximize turn-around time, our products are designed to use low cost, industry standard packages and can be tested with widely available automatic test equipment. We currently engage companies such as King Yuan Electronics, SPIL, and Youngtek Electronics in Taiwan and Amkor in Korea as our primary subcontractors for the assembly and testing of our products. We have dedicated teams of manufacturing engineers who maintain control over the process from the early stages of manufacturing. Our engineers work closely with our subcontractors to develop product testing and packaging programs to ensure these programs meet our product specifications, thereby maintaining our ownership of the functional and parametric performance of our semiconductors.

*Quality and Reliability Assurance.* We have designed and implemented a quality assurance system that provides the framework for continual improvement of products, processes and customer service. To ensure consistent product quality, reliability and yield, our quality assurance teams perform reliability engineering, quality control, ISO system development, document control, subcontractor quality management and customer engineering services to closely monitor the overall process from IC design to after-sale customer support. In particular, we rely on in-depth simulation studies, testing and practical application testing to validate and verify our products. We emphasize a strong supplier quality management practice in which our manufacturing suppliers and subcontractors are pre-qualified by our quality assurance teams. Our suppliers are required to have a quality management system, certified to ISO 9000 standard. Our operations have been ISO 9001 certified since November 18, 1999.

## Competition

The semiconductor industry is characterized by intense competition. Our customers face supply shortages or oversupply, rapid technological changes, evolving industry standards and declining average selling prices.

We currently compete with other companies that produce flash memory storage controllers, such as Alcor Micro, Chipsbank, Genesys, Incomm, Phison, Samsung, Skymedi, and USBest. We may also face competition from some of our customers who may develop products or technologies internally that compete with our solution. For multimedia SoC products, the companies with whom we compete include Actions, ALi, AMD, NVIDIA, Rockchip, SigmaTel, and Vimicro. For mobile communications products, the companies with whom we compete include Analog Devices, Infineon, NXP, Qualcomm, RFMD and Skyworks.

## Intellectual Property

To protect our proprietary rights, we rely upon a combination of copyright, patent and trademark laws, laws relating to protection of other intellectual property rights, trade secrets, and confidentiality agreements with both employees and third parties. All of our employees have executed confidentiality and assignment agreements that assign and transfer any rights they may have over information developed in the course of their employment to us. In addition, prior to disclosing our confidential information and technologies to outside parties, we typically require that the parties enter into a non-disclosure agreement with us.

As of June 20, 2007, we held 16 patents in Taiwan, 24 patents in the United States, 4 patents in China, 12 patents in Korea, and 4 patents in Japan, relating to various flash management, USB application and other technologies. These patents will expire at various dates from 2007 through 2025. As of June 20, 2007, we also had a total of 19 pending patent applications in Taiwan, 27 in the United States, 10 in China and 7 in Japan and 15 in Korea. In addition, we have registered "Silicon Motion" and its logo (a three-dimensional cube depiction of the letters "SM") as trademarks in Taiwan and the United States and have made application in China and Japan to register the mark. FCI, the FCI logo, airRF, basicRF, ezRF, ezSYS, powerRF, twinRF, zipRF and zipSYS are also our trademarks or registered trademarks.

We typically enter into license agreements with relevant third parties under which we produce our products. Such third parties include intellectual property vendors such as computer aided design tool vendors and software vendors.

We expect to continue to file patent applications where appropriate to protect our proprietary technologies. We applied for 36 patents in 2006 and intend to apply for at least five patents in 2007. We may need to enforce our patents or other intellectual property rights, or to defend ourselves against claimed infringement of the rights of others through litigation, which could result in substantial costs and a diversion of our resources and of our efforts to procure other intellectual property rights. See Item 3 — "Risk Factors — Risks Related to Our Business — Failure to protect our proprietary technologies or maintain the right to certain technologies may negatively affect our ability to compete."

## Employees

The following table sets forth the number of our employees categorized by function as of the dates indicated.

	As of December 31,		
	2004	2005	2006
Management and administration	29	44	64
Operations	9	10	11
Research and development	69	141	202
Sales and marketing	32	47	84
Total	<u>139</u>	<u>242</u>	<u>361</u>

## [Table of Contents](#)

As of December 31, 2006, we had 361 employees, including 235 in Taiwan, 31 in the United States, 88 in China, and 7 in Japan and Korea.

We do not have any collective bargaining arrangements with our employees. We consider our relations with our employees to be good.

In November 2004, SMI Taiwan established an employee share option plan under which SMI Taiwan could issue options in respect of a maximum of 8,000 units, each unit comprising 1,000 common shares in the capital of SMI Taiwan. After the establishment of the plan, options in respect of a total of 4,000 units, or 4,000,000 shares, were issued. Each option is valid for six years and exercisable under a vesting schedule commencing from the second year after issuance. In connection with the share exchange between us and the shareholders of SMI Taiwan that we completed on April 25, 2005, we have agreed to assume these options so that they became options to purchase the equivalent number of our ordinary shares based on the one-for-one ratio in the share exchange. Subsequently on June 3, 2005, the Company amended the Plan such that options under the Plan are granted at an exercise price not lower than the market value of the Company's ordinary shares at the date of the grant and vest over four years at certain percentages after one year from the date of grant.

SMI Taiwan has a defined pension plan for all regular employees. This plan provides benefits based on the length of services and average monthly salary computed based on the final six months of employment. SMI Taiwan currently makes monthly contributions, equal to 2% of salaries, to a pension fund for its employees. Under the Labor Pension Act of Taiwan, which went into effect beginning July 1, 2005, eligible employees may elect to be subject to the pension mechanism under this act, which would require SMI Taiwan to contribute at least 6% of each employee's monthly salary.

### **Facilities**

Our headquarters in Taiyuan Science Park, Jhubei City, Hsinchu County, Taiwan, consisting of our finance, administration, human resource, MIS (IT), operations, research and development and management departments, is located in a leased space of approximately 37,500 square feet. We lease the premises under a two-year term lease, expiring February 28, 2008, and a three-year lease, expiring March 15, 2008. We also lease premises in Taipei, Taiwan, which occupies approximately 24,000 square feet under a one-year lease, expiring May 31, 2008 and a two-year lease, expiring November 30, 2008; in Milpitas, California, under a five-year lease, commencing April 1, 2007 and expiring March 31, 2012, which occupies approximately 12,000 square feet; in Shanghai, China, under a two-year lease, expiring May 7, 2008, which occupies approximately 15,900 square feet; in Shenzhen, China, under a two-year lease, expiring January 17, 2009, which occupies approximately 9,500 square feet; in Shin-Yokohama, Japan, under a two-year lease, expiring March 25, 2007, and which occupies approximately 1,500 square feet; and in Seoul, Korea, under a two-year lease, expiring February 27, 2009, and which occupies approximately 1,300 square feet.

We conduct research and development pertaining to our products at our facilities in Taiwan, China, and California. We implement our sales and marketing initiatives through our sales offices located in Taiwan, China, Korea, Japan and California.

With our recent acquisition of FCI, we also have additional operating facilities in Korea, China and California. The facilities in Seoul, Korea, which houses our mobile communications business management, research and development, sales, operations, finance and other functions, is an approximately 22,677 square feet leased premise under a three-year lease, expiring August 9, 2008. FCI also leases a small office in San Jose, California which houses a sales function and maintain a representative office in Beijing, China with sales and engineering support and a design team.

We own commercial property in Sizhi, Taipei, Taiwan of approximately 6,000 square feet, which is currently not used and which we have leased out as office premises.

We believe that adequate facilities are available to accommodate our future expansion plans.

## [Table of Contents](#)

### ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

### ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The following discussion of our financial condition and results of operations is based upon and should be read in conjunction with our consolidated financial statements and their related notes included in this annual report. This discussion contains forward-looking statements that involve risks and uncertainties. We caution you that our business and financial performance are subject to substantial risks and uncertainties. Actual results could differ materially from those projected in the forward-looking statements. In evaluating our business, you should carefully consider the information provided under the caption "Risk Factors" included in Item 3 of this annual report.

#### Principal Factors Affecting Our Results of Operations

*Net sales.* Our net sales consist primarily of sales of our semiconductors, after deducting sales discounts and allowances for returns. We have achieved significant sales growth since our inception, primarily due to significant increases in the number of semiconductors we have sold, offset partially by the lower average selling prices of each type of semiconductor. We compete primarily in the markets for controllers for flash-based storage products and multimedia SoCs. Our products primarily consist of controllers for flash memory cards, USB flash drives and flash card readers, and SoCs for MP3 players, embedded graphics applications, and PC cameras. Net sales generated by these product groups for the periods indicated were as follows:

	Year Ended December 31,					
	2004		2005		2006	
	NT\$	%	NT\$	%	NT\$	%
(in thousands, except percentage data)						
<b>Net Sales</b>						
Mobile storage products <sup>(1)</sup>	1,865,699	86	2,270,121	85	3,004,507	87
Multimedia SoCs <sup>(2)</sup>	285,441	13	402,139	15	432,072	12
Other products <sup>(3)</sup>	15,587	1	14,232	—	23,880	1
<b>Total</b>	<b>2,166,727</b>	<b>100</b>	<b>2,686,492</b>	<b>100</b>	<b>3,460,459</b>	<b>100</b>

(1) Includes controllers for flash memory cards, USB flash drives and flash card readers.

(2) Includes multimedia display processors and portable audio SoCs. We began shipping our portable audio SoCs in the first quarter of 2005.

(3) Includes primarily demo boards.

We market and sell our products worldwide through a combination of direct sales personnel focusing on sales to ODMs and OEMs that tend to purchase in higher volumes, as well as through independent distributors focusing on customers that generally purchase in smaller volumes. We have direct sales personnel in Taiwan and the United States. Most of our controllers for mobile storage products are sold to large customers who tend to buy in higher volumes, and therefore we sell most of these products through our direct sales personnel (83% and 79% for the years ended December 31, 2005 and 2006, respectively), with a smaller portion sold through independent distributors (17% and 21% for the years ended December 31, 2005 and 2006, respectively). Most of our multimedia SoCs such as multimedia display processors are sold through independent distributors (75% and 77% for the years ended December 31, 2005 and 2006, respectively), as our multimedia display processors are mainly sold to a broader group of customers who tend to buy in smaller volumes.

In determining whether to sell directly or through distributors, we consider, among other factors, our experience in those particular markets, creditworthiness of customers, our ability to identify customers, extent of volume demand in the market and our ability to provide technical support easily in the market.



## [Table of Contents](#)

For the years ended December 31, 2004, 2005 and 2006 we derived approximately 59%, 59%, and 58%, respectively, of our net sales from customers located in Taiwan and approximately 31%, 19%, and 10%, respectively, of our net sales from customers located in the United States. We anticipate that a majority of our net sales will continue to come from customers located outside of the United States. The percentages of our net sales by geographic area for the periods indicated were as follows:

Country	Year Ended December 31,		
	2004	2005	2006
Taiwan	59%	59%	58%
United States	31%	19%	10%
Others	10%	22%	32%

Our net sales are denominated in U.S. dollars and NT dollars. The percentages of our net sales by currency for the periods indicated are set forth in the following table:

Currency	Year End December 31,		
	2004	2005	2006
U.S. dollars	57%	54%	57%
NT dollars	43%	46%	43%

The length of our sales cycle, from the day purchase orders are received until products are shipped to customers, is dependent on the availability of our product inventories. If we do not have sufficient inventories on hand to meet customer demands, it generally requires approximately three months from the day purchase orders are received until finished goods are manufactured and shipped to customers. This cycle can take up to six months during times when capacity at independent foundries is being fully utilized. The potential delays inherent in the manufacturing process increase the risk that we may not be able to fulfill a customer's order on time. All of our sales are made by purchase orders. Because our practice, which is consistent with industry practice, allows customers to reschedule orders on relatively short notice, order backlog may not be a good indicator of our future sales.

Because many of our semiconductor solutions are designed for the multimedia consumer electronics market such as flash-based storage products, MP3 players and PC cameras, we expect our business to be subject to seasonality, with increased net sales in the second half of each year, when customers place orders to meet increased demand for year-end holiday seasons, and generally, decreased net sales in the first half of each year. However, our recent rapid sales growth makes it difficult for us to assess the impact of seasonal factors on our business.

*Cost of sales.* Our cost of sales consists primarily of the following costs:

- cost of wafer fabrication;
- assembly, testing and shipping costs of our semiconductors;
- personnel and equipment costs associated with manufacturing support;
- quality assurance and occupancy costs paid to third-party manufacturers; and
- cost of raw materials, for example, SDRAM used with our graphics processors.

We engage independent foundries for the manufacturing and processing of our semiconductors. Our manufacturing cost is subject to the cyclical supply and demand conditions typical of the semiconductor industry. Our cost per wafer generally fluctuates with the availability of capacity at independent foundries. We believe that our cost of sales is substantially variable in nature, and will likely fluctuate as market conditions in the semiconductor industry change.

## [Table of Contents](#)

*Research and development expenses.* Our research and development expenses consist primarily of employee salaries and contractor costs, stock-based compensation expense, fees paid for the use of intellectual properties and design tools developed by third parties, development cost of software, expenses for the design, development and testing of system architecture, new product or product alternatives, costs for the construction of prototypes, occupancy costs and depreciation on research and development related equipment. We expense research and development expenditures as they are incurred. We expect research and development expenses to increase in future periods in absolute terms as we continue to broaden and strengthen our product portfolio.

*Sales and marketing expenses.* Our sales and marketing expenses consist primarily of employee salaries and related costs, stock-based compensation expense, commissions paid to independent distributors and costs for our advertising and promotional activities. We expect that our sales and marketing expenses will increase in absolute terms over the next several years. However, we believe that as we continue to achieve scale and greater operating efficiencies, our sales and marketing expenses may over time decline as a percentage of our net sales.

*General and administrative expenses.* Our general and administrative expenses consist primarily of general employee salaries and related costs, stock-based compensation expense, insurance premiums, professional fees and allowance for doubtful accounts. We expect that general and administrative expenses will increase in absolute terms in future periods as we continue to expand our operations, and as a result of the increased costs necessary to comply with the legal and regulatory requirements applicable to publicly listed companies in the United States.

*Accounting for stock-based compensation.* The SFAS No. 123(R) was adopted on January 1, 2006. We recognize stock compensation expense over the requisite service period of the individual grantees, which generally equals the vesting period.

We elected the modified prospective application method for adopting SFAS No. 123(R). Under this method, the unrecognized expense of awards not yet vested at January 1, 2006, the date of adoption is recognized in net income in the periods after the date of adoption using the same Black-Scholes valuation method and assumptions determined under the original provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," as disclosed in our previous annual report.

*Non-operating income and expenses.* Our non-operating income and expenses include our gains or losses on the sales of our investment, our interest from deposited cash or short-term investments, our gains or losses on foreign exchange rates, our impairment of any long-term investments, our interest paid on capital leases and other non-operating income and expenses not categorized above. We conduct an assessment on the value of our long-term investments annually, generally at the end of every fiscal year, and make corresponding adjustments as needed to the value of our long-term investments.

*Provision for income taxes.* We accrue income taxes at the applicable statutory rates in accordance with the jurisdictions where our subsidiaries are located and as adjusted for certain items including accumulated losses carried forward, non-deductible expenses, research and development tax credits, certain tax holidays, as well as changes in our deferred tax assets and liabilities and related valuation allowance. Furthermore, Taiwan tax regulations require our Taiwan subsidiary to pay an additional 10% tax on unappropriated earnings. The Taiwan government enacted the Alternative Minimum Tax Act (the AMT Act), which became effective on January 1, 2006. The alternative minimum tax (AMT) imposed under the AMT Act is a supplemental tax levied at a rate of 10% which is payable if the income tax payable determined pursuant to the Income Tax Law is below the minimum amount prescribed under the AMT Act. In addition, Taiwan law offers preferential tax treatments to industries that are encouraged by the Taiwan government. These preferential tax treatments include five-year tax exemptions for income attributable to expanded production capacity or newly developed technologies funded in whole or in part by proceeds from initial capital investments made by our shareholders, or subsequent capital increases, or capitalization of our retained earnings. Such tax exemptions may be available either to the shareholders of a company, or, if the shareholders so determine, to the company itself. SMI Taiwan has filed

three applications for such tax exemptions as SMI Taiwan had used the proceeds of the share offerings it received in 2002, 2003 and 2004 to fund eligible research and development projects. In the first quarter of 2005, SMI Taiwan received (a) all approvals, including shareholders' consent for tax exemptions in connection with research and development projects using funds raised in 2002, which exemptions have become effective as of January 1, 2005; (b) the preliminary approval and shareholders' consent for tax exemptions in connection with research and development projects using funds raised in 2003, and (c) the preliminary approval for tax exemptions in connection with research and development projects using funds raised in 2004. We intend to let SMI Taiwan enjoy the tax exemptions in connection with research and development projects using funds raised in 2004. Once all the required governmental approvals and shareholders' consents are received for particular research and development projects, SMI Taiwan will be entitled to tax exemptions for income derived from products using technologies from such projects for five years, starting from the fiscal year determined by SMI Taiwan in accordance with relevant regulations. With a combination of tax credits and exemptions, we expect our effective tax rate to be lower than the statutory tax rate, so long as we are able to continue to take advantage of the Taiwanese government's favorable tax policies. See "Risk Factors — Risks Related to Our Business — Our business depends on the support of the Taiwanese government, and a decrease in this support may increase our tax liabilities and decrease our net income" for the risks related to our ability to enjoy favorable tax policies of the Taiwanese government.

### **Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States.

The preparation of our consolidated financial statements requires us to make estimates and judgments that affect the reported amount of assets, liabilities, net sales and expenses, and related disclosure of contingent assets and liabilities. We evaluate our estimates on an on-going basis, including those related to product returns and pricing allowances, allowances for doubtful accounts, inventories, long-lived assets, income taxes, litigation and contingencies. We base our estimates and judgments on our historical experience, knowledge of current conditions and our beliefs of what could occur in the future considering available information. Because our estimates may vary in each situation, our actual results may differ from our estimates under different assumptions and conditions.

Our management considers the following factors in reviewing our financial statements:

- the selection of critical accounting policies; and
- the judgments and other uncertainties affecting the application of those critical accounting policies.

The selection of critical accounting policies, the judgments and other uncertainties affecting the application of those policies and the sensitivity of reported results to changes in conditions and assumptions are factors to be considered when reviewing our financial statements. Our principal accounting policies are set forth in detail in Note 2 to our consolidated financial statements included elsewhere in this annual report.

We believe the following critical accounting policies affect our more significant judgments used in the preparation of our financial statements.

*Revenue recognition.* Revenue from product sales are generally recognized upon shipment to the customer provided that we have received a signed purchase order, the price has been fixed or is determinable, transfer of title has occurred in accordance with the shipping terms specified in the arrangement with the customer, collectability from the customer is considered reasonably assured, product returns are reasonably estimable and there are no remaining significant obligations or customer acceptance requirements.

## [Table of Contents](#)

We record reserves to cover the estimated returns from our customers. Certain of our distributors have limited rights of return and price protection rights on unsold inventory. The return rights are generally limited to five percent of the monetary value of products purchased within the preceding six months, provided the distributor places a corresponding restocking order of equal or greater value. The allowance for sales returns for distributors and all customers is recorded at the time of sale based on historical returns information available, management's judgment and any known factors at the time the financial statements are prepared that would significantly affect the allowance. However, because of the inherent nature of estimates, actual returns and allowances could be significantly different from our estimates. To the extent rates of return change, our estimates for the reserves necessary to cover such returns would also change which could have a negative impact on our recorded revenue and gross margin. For the years ended December 31, 2004, 2005, and 2006, our allowance for sales returns was approximately NT\$16.8 million, NT\$18.1 million and NT\$ 35.1million (US\$1.1 million), respectively, representing approximately 1.0%, 1.0% and 1.0% of our gross sales for those respective periods.

Occasionally, we have reduced our product pricing due to market conditions, competitive considerations and other factors. Price protection rights are granted to certain distributors under our distribution agreements. When we reduce the price of our products, it allows the distributor to claim a credit against its outstanding accounts receivable balances based on the new price of the inventory it has on hand as of the date of the price reduction. A reserve for price adjustments is recorded at the time of sale based on our historical experience. During 2006, we incurred actual price adjustments to distributors of approximately NT\$512 thousand (US\$16 thousand).

*Allowance for doubtful accounts.* We record an allowance for doubtful accounts based on our evaluation of the collectability of our accounts receivable. Normal payment terms are provided to customers and apply upon transfer of title. On an ongoing basis, we analyze the payment history of customer accounts, including recent customer purchases. In circumstances where we are aware of a specific customer's inability to meet its financial obligations to us, we record a specific allowance against amounts due to reduce the net recognized receivable to the amount we reasonably believe will be collected. For all other accounts receivable due from customers, we categorize accounts receivables and make provisions based on a percentage of each category. We determine these percentages by examining our historical collection experience and current trends in the credit quality of our customers as well as our internal credit policies. If the financial condition of our customers, or economic conditions in general, were to deteriorate, additional allowances may be required in the future and such additional allowances would increase our operating expenses and therefore reduce our operating income and net income.

As of December 31, 2005 and 2006 our allowance for trade-related doubtful accounts was approximately NT\$6.0 million and NT\$19.6 million (US\$0.6 million), respectively, both representing approximately 1.0% of our gross accounts receivables as of those respective dates. In 2006, we also wrote-off a NT\$40.0 million (US\$1.2 million) non-trade related receivable, the collection of which we believe is doubtful.

*Inventory valuation.* We value inventories at the lower of cost or market value which represents the replacement cost for raw materials and net realizable value for finished goods and work in process. We write down our inventory for estimated obsolescence or unmarketable inventory in an amount equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those we projected, additional inventory write-downs may be required. Inventory impairment charges establish a new cost basis for inventory and charges are not subsequently reversed to income even if circumstances later suggest that increased carrying amounts are recoverable. In estimating our reserves for obsolescence, we primarily evaluate estimates based on the timing of the introduction of our new products and the quantities remaining of our old products and provide reserves for inventory on hand in excess of the estimated demand.

*Valuation of long-lived assets and intangible assets.* We evaluate the recoverability of long-lived assets and intangible assets whenever events or changes in circumstances indicate the carrying value may not be recoverable. The carrying value of a long-lived asset is considered impaired when the anticipated undiscounted cash flows from such asset is separately identifiable and is less than the carrying value. If impairment occurs, a

## [Table of Contents](#)

loss based on the excess of carrying value over the fair market value of the long-lived asset is recognized. Fair market value is determined by reference to quoted market prices, if available, or discounted cash flows, as appropriate. The impairment evaluations and the estimate of fair market value involve management estimates of assets' useful lives and future cash flows. Actual useful lives and cash flows could be different from those estimated by our management. This could have a material effect on our operating results and financial condition. During 2004 and 2005, we recognized impairment losses of approximately NT\$11.7 million and NT\$0 million (US\$0 million), respectively, on the intangible assets identified for the acquisition of SMI USA. Factors we consider that could trigger additional impairment review relate to operating losses, significant negative industry trends, underutilization of the assets, or significant changes in how we use the assets or our plans for their use.

*Accounting for income taxes.* In preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income within the relevant jurisdiction and to the extent we believe that recovery is not likely, we must establish a valuation allowance. We have provided for a valuation allowance to the extent we believe that it is more likely than not that the deferred tax assets will not be recovered from future taxable income. Should we determine that we would not be able to realize all or part of our net deferred tax asset in the future, an additional allowance for the deferred tax asset would be charged to income in the period such determination was made.

*Litigation and contingencies.* From time to time, we have been subject to legal proceedings and claims with respect to such matters as patents and other actions arising out of the normal course of business, as well as other matters identified in "Legal Proceedings, Item 8 of this Annual Report." Our success and future revenue growth will depend, in part, on our ability to protect our intellectual property. We rely on a combination of patent, copyright, trademark and trade secret laws, as well as nondisclosure agreements and other methods, to protect our proprietary technologies. We have been issued patents and may have additional patents in the future; however, we cannot provide assurance that any patent will be issued as a result of any applications or, if issued, that any claims allowed will be sufficiently broad to protect our technology. In addition, it is possible that existing or future patents may be challenged, invalidated or circumvented. It may be possible for a third party to copy or otherwise obtain and use our products or technology without authorization, develop corresponding technology independently or design around our patents. Effective copyright, trademark and trade secret protection may be unavailable or limited in foreign countries. These disputes may result in costly and time consuming litigation or the license of additional elements of our intellectual property for free.

It is possible that other companies might pursue litigation with respect to any claims such companies purport to have against us. The results of any litigation are inherently uncertain. In the event of an adverse result in any litigation with respect to intellectual property rights relevant to our products that could arise in the future, we could be required to obtain licenses to the infringed technology, pay substantial damages under applicable law, cease the use and sale of infringing products or to expend significant resources to develop non-infringing technology. Litigation frequently involves substantial expenditures and can require significant management attention, even if we ultimately prevail.

We have been or are currently involved in various claims and legal proceedings and have incurred certain costs associated with defending litigation matters. Periodically, we review the status of each significant matter and assess the potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be estimated, we accrue a liability for the estimated loss. Because of uncertainties related to these matters, accruals are based only on the best information available at the time.

Given the uncertainties associated with litigation, if our assessments prove to be wrong, or if additional information becomes available such that we estimate that there is a possible loss or possible range of loss

## [Table of Contents](#)

associated with these contingencies, then we would record the minimum estimated liability, which could have a material and adverse effect on our operations, financial condition and cash flows.

### Results of Operations

The following table sets forth our statements of operations as a percentage of net sales for the periods indicated:

	Year Ended December 31,		
	2004	2005	2006
Net sales	100.0%	100.0%	100.0%
Cost of sales	58.8	50.0	46.6
Gross profit	41.2	50.0	53.4
Operating expenses (income):			
Research and development	11.0	13.9	14.5
Sales and marketing	6.5	5.8	5.8
General and administrative	4.8	4.8	6.3
Amortization of intangible assets	0.8	0.2	—
Impairment of intangible assets	0.6	—	—
Compensation to customers	—	0.3	—
Write-off other receivable	—	—	1.2
Compensation from litigation settlement	—	—	(0.1)
Total operating expenses	23.7	25.0	27.7
Operating income	17.5	25.0	25.7
Non-operating income (expenses):			
Gain on sales of investments — net	0.5	0.4	0.5
Interest income	0.0	1.0	1.9
Interest expense	(0.0)	(0.0)	(0.0)
Foreign exchange gain (loss) — net	0.6	0.1	(0.2)
Impairment of long-term investments	(0.1)	—	—
Other income (expense), net	0.0	0.1	0.1
Total non-operating income	1.0	1.6	2.3
Income before income taxes	18.5	26.6	28.0
Income tax (benefit) expense	6.1	1.6	0.6
Net income	12.4%	25.0%	27.4%

### Comparison of Year Ended December 31, 2006 to Year Ended December 31, 2005

*Net sales.* Our net sales for the year ended December 31, 2006 were approximately NT\$3,460.5 million (US\$106.2 million) compared to approximately NT\$2,686.5 million for the year ended December 31, 2005, an increase of approximately 29%. The increase in our net sales was primarily due to an increase in net sales from our mobile storage product, which had increased from 85% of overall net sales in 2005 to 87% of overall net sales in 2006.

The increase in the net sales of our mobile storage products was due to strong volume demand for our mobile storage products, especially our controllers for flash memory cards, partially offset by declining average selling prices. The strong volume demand for our mobile storage products was due in part to the growing demand for digital multimedia devices that use flash-based storage medium, combined with what we believe to be our favorable competitive position in the markets that we serve, which we believe is primarily due to our ability to

## [Table of Contents](#)

deliver products that are universally compatible, highly efficient and require minimal power consumption at competitive cost and to provide comprehensive post-sale support services.

For the year ended December 31, 2006, we shipped approximately 160.8 million units of semiconductors for mobile storage products in total, an increase of approximately 103% from approximately 79.4 million units for the year ended December 31, 2005. Total unit shipment of our multimedia SoCs for the year ended December 31, 2006 remained unchanged at 1.8 million units with the year ended December 31, 2005.

*Cost of sales.* Our cost of sales grew to approximately NT\$1,612 million (US\$49.5 million) for the year ended December 31, 2006 from approximately NT\$1,342.7 million in 2005. Our cost of sales as a percentage of net sales declined from approximately 50.0% of our net sales in 2005 to 46.6% of our net sales in 2006. Our cost of sales increased as a result of the increased number of semiconductors sold. However, our cost per unit declined because of several factors. Our cost per unit declined as we migrated our manufacturing process technology to smaller geometries which increased the number of dies per silicon wafer and lowered our unit cost. A second factor was the shift towards shipping a larger percentage of our flash memory controllers in bare die form. The lack of chip assembly removed a cost component that we had previously passed along to our customers without much mark-up. A third factor was that wafer prices in general were lower in 2006 than in 2005.

*Gross profit.* Our gross margin increased to 53.4% for the year ended December 31, 2006 from 50.0% for the year ended December 31, 2005 due to improvements in our cost of sales.

*Research and development expenses.* Our research and development expenses increased to approximately NT\$502.2 million (US\$15.4 million), or 14.5% of net sales, for the year ended December 31, 2006 from approximately NT\$373.5 million, or 13.9% of net sales, for the year ended December 31, 2005. Several factors contributed to the 34% increase in research and development expenses. Salary, benefits, rental and compensation expenses grew as we increased our headcount from 141 to 202 employees in our research and development group, and also as we started accounting for stock-based compensation in 2006, the amount of which was NT\$37.7 million. Our project expense increased as we continued to invest in card readers, portable audio SoCs for MP3 players and image processor for PC cameras. We expect research and development expenses to increase in absolute terms in future periods as we continue to increase our staffing and associated costs to pursue additional product development opportunities.

*Sales and marketing expenses.* Our sales and marketing expenses increased to approximately NT\$200.5 million (US\$6.2 million), or 5.8% of net sales, for the year ended December 31, 2006 from approximately NT\$157.3 million, or 5.8% of net sales, for the year ended December 31, 2005. Several factors contributed to the 28% increase in sales and marketing expenses. Salary, benefits, rental and compensation expenses grew as we increased our headcount from 47 to 84 employees in our sales and marketing group, and also as we started accounting for stock-based compensation in 2006, the amount of which was NT\$13.5 million. We expect sales and marketing expenses to increase in dollar amount in future periods as we continue to increase the size of our operations.

*General and administrative expenses.* Our general and administrative expenses increased to approximately NT\$219.4 million (US\$6.7 million), or 6.3% of net sales, for the year ended December 31, 2006 from approximately NT\$129.1 million, or 4.8% of net sales, for the year ended December 31, 2005. Several factors contributed to the 70% increase in general and administrative expenses. Salary, benefits, rental and compensation expenses grew as we increased our headcount from 44 to 64 employees in our general and administrative group, and also as we started accounting for stock-based compensation in 2006, the amount of which was NT\$31.0 million. Our general and administrative expenses also increased because of higher costs necessary to comply with the legal and regulatory requirements applicable to publicly listed companies in the United States. We expect our general and administrative expenses to increase in absolute dollars in future periods as we continue to expand our operations.

## [Table of Contents](#)

*Write-Off of OtherReceivables.* For the year ended December 31, 2006, we wrote-off a NT\$40.0 million (US\$1.2 million) non-trade receivable, the collection of which we believed was doubtful. We did not have a similar write-off for the year ended December 31, 2007.

*Interest expense.* Our interest expense decreased to approximately NT\$33,000 (US\$1,013) for the year ended December 31, 2006 from approximately NT\$46,000 for the year ended December 31, 2005. Our interest expense for 2006 decreased as a result of less capital lease payments under which we rented some of our office equipment in our US subsidiary.

*Gain from litigation settlement.* Our dispute with Phison was settled on September 22, 2006 after Phison paid us NT\$3,000 thousand (US\$92 thousand).

*Foreign exchange gain (loss).* For the year ended December 31, 2006, we incurred a foreign exchange loss of NT\$5.2 million (US\$0.2 million), compared with a gain of NT\$1.8 million for the year ended December 31, 2005. The foreign exchange loss is attributable to the weakening of the exchange rate of the NT dollar as compared to the U.S. dollar during the period.

*Interest income.* Our interest income increased to approximately NT\$65.2 million (US\$2.0 million) for the year ended December 31, 2006 from approximately NT\$26.9 million for the year ended December 31, 2005. Our interest income increased as a result of increases in our cash and cash equivalent position as well as rising interest rates.

*Income tax expense.* Our income tax expense decreased to approximately NT\$21.0 million (US\$0.6 million) for the year ended December 31, 2006 from an income tax expense of approximately NT\$42.1 million for the year ended December 31, 2005. Our income tax expense decreased primarily as a result of income tax credit earned in 2006.

*Net income.* As a result of the foregoing, our net income increased to approximately NT\$947.5 million (US\$29.1 million) for the year ended December 31, 2006 from approximately NT\$673.3 million for the year ended December 31, 2005.

### **Comparison of Year Ended December 31, 2005 to Year Ended December 31, 2004**

*Net sales.* Our net sales for the year ended December 31, 2005 were approximately NT\$2,686.5 million compared to approximately NT\$2,166.7 million for the year ended December 31, 2004, an increase of approximately 24%. The increase in our net sales was primarily due to an increase in sales volume from our key products. Net sales from our mobile storage products and multimedia SoCs were approximately 85% and 15%, respectively, of total net sales for the year ended December 31, 2005.

The increase in our sales volume was due to strong demand for our new mobile storage products, including our SM263 and SM264 flash memory controllers and SM321 USB 2.0 flash disk drive controller, and for our multimedia SoCs. The strong demand for our products was due in part to the growing demand for digital media devices that use flash-based storage medium and for MP3 players, combined with what we believe to be our favorable competitive position in the markets that we serve. We believe that our favorable competitive position in the market is primarily due to our ability to deliver products that are universally compatible, highly efficient and require minimal power consumption at competitive cost and to provide comprehensive post-sale support services.

For the year ended December 31, 2005, we shipped approximately 79.4 million units of semiconductors for mobile storage products in total, an increase of approximately 132% from approximately 34.3 million units for the year ended December 31, 2004. Total unit shipment of our multimedia SoCs increased by approximately 299% from 465,000 units for the year ended December 31, 2004 to 1.8 million units for the year ended December 31, 2005.



## [Table of Contents](#)

*Cost of sales.* Our cost of sales grew to approximately NT\$1,342.7 million for the year ended December 31, 2005 from approximately NT\$1,274.4 million in 2004. Our cost of sales was approximately 50.0% of our net sales in 2005 compared to 58.8% of our net sales in 2004. Our cost of sales increased as a result of the increased number of semiconductors sold. However, our cost per unit declined as a result of the migration of our manufacturing process technology to smaller geometries which increased the number of dies per silicon wafer and lowered our unit cost, and the fact that a larger percentage of our flash memory controllers were shipped in bare die form, which saved us significant costs associated with packaging.

*Gross profit.* Our gross margin was 50.0% for the year ended December 31, 2005 compared with 41.2% for the year ended December 31, 2004. Several factors contributed to the increase in gross margin. We migrated our manufacturing process technology to smaller geometries, which increased the number of dies per silicon wafer and lowered our unit cost. A second factor was the shift towards shipping a larger percentage of our flash memory controllers in bare die form. The lack of chip assembly removed a cost component that we had previously passed along to our customers without much mark-up. A third factor was that wafer prices in general were lower in 2005 than in 2004.

*Research and development expenses.* Our research and development expenses increased to approximately NT\$373.5 million, or 13.9% of net sales, for the year ended December 31, 2005 from approximately NT\$238.5 million, or 11.0% of net sales, for the year ended December 31, 2004. Several factors contributed to the 57% increase in research and development expenses. Salary, benefits, rental and travel expenses grew as we increased our headcount from 69 to 141 employees in our research and development group. Our project expense increased as we continued to invest in new versions of our flash memory controllers and USB 2.0 flash disk drive controllers, portable audio SoCs for MP3 players and image processor for PC cameras. We expect research and development expenses to increase in absolute terms in future periods as we continue to increase our staffing and associated costs to pursue additional product development opportunities.

*Sales and marketing expenses.* Our sales and marketing expenses increased to approximately NT\$157.3 million, or 5.8% of net sales, for the year ended December 31, 2005 from approximately NT\$141.1 million, or 6.5% of net sales, for the year ended December 31, 2004. Our sales and marketing expenses increased by approximately 11% from 2004 to 2005 primarily as a result of increases in salary, benefits and office rental expense arisen from increased headcount as well as higher commission. We expect sales and marketing expenses to increase in dollar amount in future periods as we continue to increase the size of our operations.

*General and administrative expenses.* Our general and administrative expenses increased to approximately NT\$129.1 million, or 4.8% of net sales, for the year ended December 31, 2005 from approximately NT\$103.3 million, or 4.8% of net sales, for the year ended December 31, 2004. Our general and administrative expenses increased by approximately 25% as a result of higher professional fees, primarily as a result of our being a public company, higher travel expense and miscellaneous expenses. We expect our general and administrative expenses to increase in absolute dollars in future periods as we continue to expand our operations.

*Amortization of intangible assets.* Our expense relating to amortization of intangible assets decreased to approximately NT\$4.5 million for the year ended December 31, 2005 from approximately NT\$17.8 million for the year ended December 31, 2004. This expense was associated with the annual amortization of intangible assets relating to our acquisition of SMI USA in August 2002. Our amortization expense was lower in 2005 as a result of our recognition of impairment charges related to these acquired intangible assets in 2004.

*Impairment of intangible assets.* The charge for impairment of intangible assets was zero for the year ended December 31, 2005, compared to NT\$11.7 million for the year ended December 31, 2004. During the fourth quarter of 2004, we determined that impairment of the intangible asset, developed technology, occurred as a result of a significant decline in expected net sales from the introduction of new consumer products such as broadband Internet video phones, car navigation systems, and Tablet PCs. As the development and market for these products did not materialize, the forecasted revenues and cash flows were significantly reduced. We

## [Table of Contents](#)

estimated the undiscounted cash flows taking into account the new information and determined that the carrying value of the developed technology was higher than the estimated cash flows. Accordingly, we reduced the carrying value of the developed technology to the fair value as determined by the estimated discounted cash flows.

*Interest expense.* Our interest expense decreased to approximately NT\$46,000 for the year ended December 31, 2005 from approximately NT\$169,000 for the year ended December 31, 2004. Our interest expense for 2005 decreased as a result of the termination of some capital leases under which we rented some office equipment in our US subsidiary.

*Foreign exchange gain.* The foreign exchange gain was due to change in exchange rates decreased from NT\$13.7 million in 2004 to NT\$1.8 million in 2005. This increase is attributable to the weakening of the exchange rate of the NT dollar as compared to the U.S. dollar during the periods.

*Interest income.* Our interest income increased to approximately NT\$26.9 million for the year ended December 31, 2005 from approximately NT\$0.6 million for the year ended December 31, 2004. Our interest income increased as a result of increases in our cash and cash equivalent position as well as rising interest rates.

*Income tax expense.* Our income tax expense decreased to approximately NT\$42.1 million for the year ended December 31, 2005 from an income tax expense of approximately NT\$133.1 million for the year ended December 31, 2004. Our income tax expense decreased primarily as a result of the five-year tax exemptions for income attributable to expanded production capacity or newly developed technologies, starting in 2005.

*Net income.* As a result of the foregoing, our net income increased to approximately NT\$673.3 million for the year ended December 31, 2005 from approximately NT\$268.0 million for the year ended December 31, 2004.

### **Liquidity and Capital Resources**

As of December 31, 2006, we had approximately NT\$1,808.0 million (US\$55.5 million) in cash and cash equivalents, approximately NT\$1,458.8 million (US\$44.8 million) in short-term investments and approximately NT\$65.0 million (US\$2.0 million) in refundable deposits for reserving foundry capacity with our manufacturing partners. We maintain our cash balances in deposits with banks in Taiwan and in money market instruments offshore. Our short-term investments consist primarily of bond funds that are denominated in NT dollars and invested primarily in time deposits and Taiwan government and corporate bonds. As of December 31, 2006, we had an unutilized credit facility of NT\$70 million (US\$2.1 million) which remains uncommitted, can be used for many purposes and is subject to annual renewal.

On April 30, 2007, we acquired Future Communications IC, Inc. The final purchase price for the transaction was approximately US\$50 million in cash and US\$40 million in our ordinary shares and options to purchase our ordinary shares. Cash which we paid as part of the purchase price reduced our cash and cash equivalent and short-term investments by US\$50 million.

We believe our existing cash balances and short-term investments, together with cash we expect to be generated from operating activities, will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors, including the level of our net sales, the timing and extent of spending to support product development efforts, the expansion of sales and marketing activities, the timing of introductions of new products, the costs to ensure access to adequate manufacturing capacity, the continuing market acceptance of our products and availability of attractive acquisition opportunities. We could be required, or could elect, to seek additional funding through public or private equity or debt financing, and additional funds may not be available on terms acceptable to us or at all.

## [Table of Contents](#)

The following table sets forth a summary of our cash flows for the periods indicated:

	Year Ended December 31,		
	2005	2006	2006
	NT\$	NT\$	US\$
(In thousands)			
<b>Consolidated Cash Flow Data:</b>			
Net cash provided by (used in) operating activities	539,008	596,763	18,311
Net cash provided by (used in) investing activities	(1,011,935)	(425,010)	(13,041)
Net cash provided by (used in) financing activities	1,278,868	59,929	1,839
Depreciation and amortization	23,906	35,596	1,092
Capital expenditures	(42,708)	(271,697)	(8,337)

### *Operating activities.*

Our net cash provided by operating activities was approximately NT\$596.8 million (US\$18.3 million) for the year ended December 31, 2006, an increase of approximately NT\$57.8 million over net cash provided by operating activities of approximately NT\$539.0 million for the year ended December 31, 2005. Our net cash provided by operating activities increased in 2006 primarily as a result of our higher income from operations, our increased accounts payable and increased income tax payable and was partially offset by increases in our accounts receivable.

### *Investing activities.*

Our net cash used in investment activities includes the acquisition of long-term investment and purchase of properties was approximately NT\$425.0 million (US\$13.0 million) for the year ended December 31, 2006, compared to net cash provided by investing activities of approximately NT\$1,011.9 million for the year ended December 31, 2005. Our net cash used in investing activities in 2006 was primarily a result of our investments in Chipmast and Vastview, and prepayment of construction in progress.

### *Financing activities.*

Our net cash provided in financing activities was approximately NT\$59.9 million (US\$1.8 million) for the year ended December 31, 2006, compared to net cash provided by financing activities of approximately NT\$1,278.9 million for the year ended December 31, 2005. Proceeds of NT\$38.1 million (US\$1.2 million) were received from the issuance of 1.2 million shares of our common stock upon exercise of employee stock options. Such proceeds were used for working capital and funding research and development of new products.

## **Contractual Obligations**

The following table sets forth our commitments to settle contractual obligations in cash as of December 31, 2006:

	Amount of Commitment Maturing by Year				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
	NT\$	NT\$	NT\$	NT\$	NT\$
(In thousands)					
Operating leases	20,681	17,304	3,377	—	—
Capital leases	484	281	203	—	—
Pension	17,988	17,988	*	*	*
<b>Total commitments</b>	<b>39,153</b>	<b>35,573</b>	<b>3,580</b>	<b>—</b>	<b>—</b>

\* Our pension obligation after one year has not been estimated.

## [Table of Contents](#)

### **Off-balance Sheet Arrangements**

We currently do not have any outstanding derivative financial instruments, off-balance sheet guarantees or arrangements, interest rate swap transactions, or foreign currency forward contracts. We do not engage in any trading activities involving non-exchange traded contracts.

### **Inflation and Monetary Risk**

The principal markets for our products have been in Taiwan and the United States and we do not believe that inflation in Taiwan or the United States has had a material impact on our results of operations. The rate of inflation in Taiwan was approximately 1.6%, 2.3%, and 1.0% for 2004, 2005, and 2006, respectively.

### **Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements", which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but brings up guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for the Company beginning January 1, 2008. The Company is currently assessing the potential impact that the adoption of SFAS No. 157 will have on the results of operations and financial position of the Company, and is not yet in a position to determine such effects.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Post-Retirement Plans — An Amendment of FASB Statements No. 87, 88, 106, and 132R" (SFAS No. 158). Provisions with respect to the recognition of an asset and liability related to the funded status and the changes in the funded status to be reflected in comprehensive income are effective for fiscal years ending after December 15, 2006 and the change in measurement date provisions is effective for fiscal years ending after December 15, 2008. SFAS No. 158 also requires the measurement date of the plan's funded status to be the same as the Company's fiscal year-end. The Company adopted all requirements of SFAS No. 158 for the year ended December 31, 2006. Upon the adoption of SFAS No. 158, the Company recognized an increase to accumulated other comprehensive income of NT\$2,100 thousand as of December 31, 2006.

In July 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" ("FIN No. 48"). FIN No. 48 clarifies the accounting for uncertainty in income taxes by prescribing the recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006 and is required to be adopted by the Company in fiscal 2007. The cumulative effects, if any, of applying FIN No. 48 will be recorded as an adjustment to retained earnings as of the beginning of the period of adoption. The Company is currently evaluating the effect that the adoption of FIN No. 48 will have on the results of operations and financial position of the Company and is not yet in a position to determine such effects.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Current Year Misstatements. SAB No. 108 requires analysis of misstatements using both an income statement (rollover) approach and a balance sheet (iron curtain) approach in assessing materiality and provides for a one-time cumulative effect transition adjustment. SAB No. 108 is effective for the Company's fiscal year 2006 annual financial statements. The Company believes that there is no impact on the results of operations and financial position of the Company after adopting SAB No. 108.

In February 15, 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS No. 159). Under this standard, the Company may choose to report financial

## [Table of Contents](#)

instruments and certain other items at fair value on a contract-by-contract basis with changes in value reported in earnings. This selection is irrevocable. SFAS No. 159 provides an opportunity to mitigate volatility in reported earnings that is caused by measuring hedged assets and liabilities that were previously required to use a different accounting method than the related hedging contracts when the complex provisions of SFAS No. 133 hedge accounting are not met. The Company believes that there is no impact on the result of operations and financial position of the Company after adoption of SFAS No. 159.

### **ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES**

#### **Executive Officers and Directors**

Members of our board of directors are elected by our shareholders. Our board of directors consists of seven directors.

Our executive officers are appointed by, and serve at the discretion of, our board of directors. The following table sets forth information regarding our directors and executive officers as of the date of this annual report.

<u>Name</u>	<u>Age</u>	<u>Position</u>
James Chow	57	Chairman of the Board
Wallace C. Kou	49	President, Chief Executive Officer and Director
Henry Chen	42	Director
Tsung-Ming Chung	58	Director
C. S. Ho	58	Director
Lien-chun Liu	50	Director
Yung-Chien Wang	44	Director
Riyadh Lai	38	Chief Financial Officer
Ken Chen	46	Vice President, Operations
Frank Chang	41	Senior Director, Research and Development

#### **Executive Officers and Directors**

##### **James Chow, Chairman of the Board of Directors**

James Chow has served as the Chairman of our board of directors since April 22, 2005. Mr. Chow became the Chairman of Concord Financial Co., Ltd. in July 1993. Concord Financial Co., Ltd. is a venture capital firm and one of our significant shareholders. Since May 2003, Mr. Chow has also served as the Chairman of Waffer Technology Corporation, a manufacturer of magnesium alloy products in Taiwan. Mr. Chow received an MBA from Columbia University.

##### **Wallace C. Kou, President, Chief Executive Officer, Director**

Mr. Kou, our President and Chief Executive Officer, joined our board of directors on April 22 2005. He is responsible for our overall strategy and management. Mr. Kou founded SMI USA in 1996. Prior to founding SMI USA, Mr. Kou was the Vice President and Chief Architect at the Multimedia Products Division of Western Digital Corporation, which developed graphics processors for notebook PCs and was sold to Philips Semiconductor in 1995. Before Western Digital, Mr. Kou worked for Wyse Technology. Mr. Kou received a BS in Electrical & Control Engineering from the National Chiao Tung University in Taiwan and an MS in Electrical & Computer Engineering from the University of California at Santa Barbara.

##### **Henry Chen, Director**

Mr. Chen joined our board of directors on June 6, 2005. Mr. Chen is the Chairman of Mercuries and Associates, Ltd., a company listed on the main board of the Taiwan Stock Exchange. He was previously the

## [Table of Contents](#)

President of Worldsec Capital Management Inc. and had worked for Goldman Sachs offices in New York, Hong Kong and Taipei. Mr. Chen has a BA in International Trade from the National Chengchi University and an MBA from Georgetown University.

### **Tsung-Ming Chung, Director**

Mr. Chung joined our board of directors on June 6, 2005. Mr. Chung currently serves as the Chairman and Chief Executive Officer of Dynapack International Technology Corp, a leading provider of battery packs for notebook computer and other handheld devices. From 1985 to 2000, Mr. Chung was an audit partner at Arthur Andersen. He also serves as a supervisor of Far East International Bank and Taiwan Cellular Corp. Mr. Chung has a BA in Business Administration from the National Taiwan University and an MBA from the National Cheng-chi University.

### **C. S. Ho, Director**

Mr. Ho joined the board of directors on June 6, 2005. He currently serves as the chairman and Chief Executive Officer of SiPix Group, an electronic paper company. He also serves as Chairman of the Computer Skills Foundation in Taiwan. From 1989 to 1995, Mr. Ho served as Chairman of the Taipei Computer Association and from 1991 to 1995 as Chairman of Southeast Asia Information Technology Organization. Mr. Ho is the founder and a general partner of PTI Ventures. Prior to founding PTI Ventures, from 1974 to 1997 he founded and served as Vice Chairman of MiTAC Group. During his tenure at MiTAC, Mr. Ho built the company to an NT\$8 billion conglomerate by supplying a wide variety of products to the IT industry, including PCs and peripherals, servers and systems, telecom and data-com equipment, systems integration, software, distribution, computer education, and publications. Mr. Ho received his BS in Electrical Engineering from the National Taiwan University.

### **Lien-Chun Liu, Director**

Ms. Liu joined our board of directors on June 6, 2005. Ms. Liu is a research fellow at the Taiwan Research Institute. She also currently serves on the board of supervisors of Concord VIII Venture Capital Co., Ltd and on the board of directors of New Tamsui Golf Course. From 2000 to 2004, she also served on the board of supervisors of China Television Corp. Ms. Liu has a BA from Wellesley College and a JD from Boston College Law School.

### **Yung-Chien Wang, Director**

Mr. Wang joined our board of directors on June 6, 2005. Mr. Wang has more than 18 years of working experience in the human resource and legal services industry. Mr. Wang has been a consultant of Professional Trust Co., Ltd., a human resource consulting firm in Taiwan since August 1998 and is currently its Vice President. Mr. Wang has a law degree from Fu Jen Catholic University in Taiwan.

### **Riyadh Lai, Chief Financial Officer**

Mr. Lai joined us in April 2007 from ING Corporate Finance, Asia, where he was the Head of the Technology Group. Previously, he was with Morgan Stanley, ABN AMRO, and PepsiCo in Hong Kong and New York. Mr. Lai has over 11 years of M&A transaction experience, including eight years managing transactions involving leading global and Asian technology companies. He holds a BA degree in Economics from Georgetown University and an MBA from New York University.

### **Ken Chen, Vice President, Operations**

Mr. Chen has served as our Vice President in charge of operations since November 2003. Mr. Chen has over 20 years of manufacturing and operation experience in the semiconductor industry. He has been involved in the

## [Table of Contents](#)

management of supply chain and virtual manufacturing systems including wafer fabrication, mask tooling, assembly and testing. Mr. Chen previously served in management positions at Faraday Technology and UMC. He joined us in 2003. Mr. Chen holds a BS degree in Industrial Engineering from Chung Yuan Christian University and an MS degree in Industrial Engineering and Engineering Management from the National Tsing Hua University, Taiwan.

### **Frank Chang, Senior Director, Research & Development**

Mr. Chang has served as our director of research and development since August 2002. Mr. Chang manages the research and development department in our Hsinchu headquarters. Mr. Chang has more than 14 years of experience in the chip design industry. He was previously a project manager of firmware development at Holtek, a well-known design house of electronics ICs. Mr. Chang has a BS in Electrical Engineering from the National Changhua University of Education.

There is no arrangement or understanding with major shareholders, customers, suppliers or others, pursuant to which any person referred to above was selected as a director or member of senior management.

## **Board Practices**

### *Board Committees*

Our board of directors has established an audit committee, a compensation committee, and a nominating and corporate governance committee.

*Audit Committee.* The audit committee is responsible for reviewing the financial information that will be provided to shareholders and others, reviewing the systems of internal controls that management and the board of directors have established, appointing, retaining and overseeing the performance of the independent registered public accounting firm, overseeing our accounting and financial reporting processes and the audits of our financial statements, and pre-approving audit and permissible non-audit services provided by the independent registered public accounting firm. Messrs. Tsung-Ming Chung, Henry Chen, and Lien-chun Liu are members of our audit committee. Our board of directors has determined that Mr. Tsung-Ming Chung, the Chairman of the audit committee, is the committee's "Financial Expert" as required by Nasdaq and SEC rules.

*Compensation Committee.* The compensation committee's basic responsibility is to review the performance and development of management in achieving corporate goals and objectives and to assure that our senior executives are compensated effectively in a manner consistent with our strategy, competitive practice and the requirements of the appropriate regulatory bodies. Toward that end, this committee oversees, reviews and administers all of our compensation, equity and employee benefit plans and programs. Messrs. Henry Chen and Lien-chun Liu are members of our compensation committee, with Mr. Chen serving as the Chairman of such committee.

*Nominating and Corporate Governance Committee.* The nominating and corporate governance committee is responsible for overseeing, reviewing and making periodic recommendations concerning our corporate governance policies, and for recommending to the full board of directors candidates for election to the board of directors. Messrs. C.S. Ho, Henry Chen, Lien-chun Liu and Yung-Chien Wang are members of our nominating and corporate governance committee, with Ms. Liu serving as the Chairman of such committee.

Our board of directors has adopted a code of ethics, which is applicable to all of our employees.

We also have established a disclosure committee, which is comprised of certain members of senior management. Pursuant to the disclosure committee's charter, which was ratified by our board of directors, the disclosure committee is responsible for adopting, evaluating and overseeing our disclosure controls and procedures and internal financial controls.

### **Duties of Directors**

Under Cayman Islands law, our directors have a duty to act honestly, in good faith and with a view to the best interests of our company. Our directors also have a duty to exercise the care, diligence and skills that a reasonably prudent person would exercise in comparable circumstances. In fulfilling their duty of care to our company, our directors must ensure compliance with our memorandum and articles of association.

The functions and powers of our board of directors include, among others:

- convening shareholders' meetings and reporting its work to shareholders at such meetings;
- implementing shareholders' resolutions;
- determining our business plans and investment proposals;
- formulating our profit distribution plans and loss recovery plans;
- determining our debt and finance policies and proposals for the increase or decrease in our registered capital and the issuance of debentures;
- formulating our major acquisition and disposition plans, and plans for merger, division or dissolution;
- proposing amendments to our amended and restated memorandum and articles of association; and
- exercising any other powers conferred by the shareholders' meetings or under our amended and restated memorandum and articles of association.

### **Terms of Directors and Officers**

Under Cayman Islands law and our articles of association, our directors hold office until a successor has been duly elected and qualified. Our articles of association provide that our directors serve for a term of three years, with one-third of the directors (or, if their number is not a multiple of 3, the number nearest to but not greater than one-third) subject to reelection at each annual general meeting of shareholders (chairman and managing director not subject to retirement by rotation nor to be taken into account in determining the number of directors to retire), unless the director was appointed by the board of directors, in which case such director holds office until the next annual meeting of shareholders at which time such director is eligible for re-election. One of our seven directors is currently subject to reelection at our next annual general meeting of shareholders. All of our executive officers are appointed by and serve at the discretion of our board of directors.

### **Limitation on Liability and Other Indemnification Matters**

Cayman Islands law and our articles of association allow us to indemnify our directors, secretary and other officers acting in relation to any of our affairs against actions, costs, charges, losses, damages and expenses incurred by reason of any act done or omitted in the execution of their duties as our directors, secretary and other officers. Under our memorandum and articles of association, indemnification is not available to any matter in respect of any fraud, dishonesty, willful misconduct or bad faith which may attach to any of them.

### **Compensation of Directors and Executive Officers**

For the year ended December 31, 2006, the aggregate compensation to our directors and senior executive officers was approximately NT\$ 38.5 million (US\$ 1.18 million). In 2006, we granted options to our executive officers as a group to acquire an aggregate of 610,000 ordinary shares. The options granted to our executive officers and non-executive directors are subject to the same vesting conditions as our employees.

### **Service Contracts**

We currently do not have service contracts with our directors.



## Share-based Compensation Plans and Option Grants

In April 2005, our board of directors and shareholder adopted our 2005 Incentive Plan. Our stockholders approved our Amended and Restated 2005 Incentive Plan (referred to in this report as the “Plan”) at our Annual General Meeting in August 2006, including an amendment to increase the authorized number of shares available for issuance under the plan from 10,000,000 shares to 25,000,000 shares. The Plan provides for the grant of stock options, stock bonuses, restricted stock awards, restricted stock units and stock appreciation rights, which may be granted to our employees (including officers), directors and consultants.

*Share Reserve.* The aggregate number of ordinary shares that may be issued pursuant to awards granted under the Plan will not exceed 25,000,000 inclusive of ordinary shares issuable upon exercise of awards previously granted under the Silicon Motion, Inc. Guidelines for Issuance and Subscription of Employee Stock Option, which options we have, subject to the consent of the respective option-holders, agreed to assume in the share exchange.

The following types of shares issued under the Plan may again become available for the grant of new awards under the Plan: restricted stock issued under the Plan that is forfeited or repurchased by us prior to it becoming fully vested; shares withheld for taxes; shares tendered to us to pay the exercise price of an option; and shares subject to awards issued under the Plan that have expired or otherwise terminated without having been exercised in full.

*Administration.* The board of directors will administer the Plan and may delegate this authority to administer the plan to a committee. Subject to the terms of the Plan, the plan administrator, which is our board of directors or its authorized committee, determines recipients, grant dates, the numbers and types of stock awards to be granted and the terms and conditions of the stock awards, including the period of their exercisability and vesting. Subject to certain limitations, the plan administrator will also determine the exercise price of options granted, the purchase price for restricted stock and restricted stock units, and, if applicable, the strike price for stock appreciation rights.

*Capitalization adjustments.* In the event of a dividend or other distribution (whether in the form of cash, ordinary shares, other securities, or other property), recapitalization, stock split, reorganization, merger, consolidation, exchange of our ordinary shares or our other securities, or other change in our corporate structure, the board of directors may adjust the number and class of shares that may be delivered under the Plan and the number, class and price of the shares covered by each outstanding stock award.

*Changes in control.* In the event of a change in control of the company, all outstanding options and other awards under the 2005 Incentive Plan may be assumed, continued or substituted for by any surviving or acquiring entity. If the surviving or acquiring entity elects not to assume, continue or substitute for such awards, the vesting of such awards held by award holders whose service with us or any of our affiliates has not terminated will be accelerated and such awards will be fully vested and exercisable immediately prior to the consummation of such transaction, and the stock awards shall automatically terminate upon consummation of such transaction if not exercised prior to such event.

*Amendment and termination.* The board of directors may amend (subject to shareholder approval as required by applicable law), suspend or terminate the Plan at any time. Unless sooner terminated by the board of directors, the Plan will terminate pursuant to its terms on April 22, 2015.

## Share Ownership

Under U.S. securities law, a person is deemed to be a “beneficial owner” of a security if that person has or shares “voting power,” which includes the power to vote or to direct the voting of such security, or “investment power,” which includes the power to dispose of or to direct the disposition of such security. A person is also deemed to be the beneficial owner of any securities of which that person has a right to acquire beneficial

## [Table of Contents](#)

ownership within 60 days. Under these rules, more than one person may be deemed a beneficial owner of securities as to which such person has no economic interest.

There were 131,177,358 of our ordinary shares issued and outstanding as of June 20, 2007. The following table sets forth information with respect to the beneficial ownership of our ordinary shares as of June 20, 2007, unless otherwise indicated in the footnotes, by:

- each of our directors and officers; and
- each person known to us to own beneficially more than 5.0% of our ordinary shares.

	Shares Beneficially Owned	
	Number	%
<b>Executive Officers and Directors:</b>		
James Chow <sup>(1)</sup>	2,351,266	1.8
Wallace C. Kou <sup>(2)</sup>	2,244,194	1.7
Henry Chen <sup>(3)</sup>	20,000	*
Tsung-Ming Chung <sup>(4)</sup>	20,000	*
Lien-chun Liu <sup>(5)</sup>	120,000	*
C. S. Ho <sup>(6)</sup>	193,050	*
Yung-Chien Wang <sup>(7)</sup>	734,394	*
Riyadh Lai	—	—
Ken Chen <sup>(8)</sup>	175,725	*
Frank Chang <sup>(9)</sup>	196,333	*
<b>Principal Shareholders:</b>		
Brandywine Global Investment Management, LLC <sup>(10)</sup>	14,085,688	11.4

\* Less than one percent

- (1) Represents 2,301,266 shares owned by Mr. Chow and 50,000 shares that Mr. Chow has the right to acquire within the next 60 days upon the exercise of options. Mr. Chow is the chairman of Concord Consulting Inc. and Concord Financial Co. Ltd. which own 1,327,245 and 1,502,535 shares, respectively. Mr. Chow disclaims any beneficial ownership of these shares.
- (2) Represents 1,909,100 shares owned by Mr. Kou, 35,094 shares owned by his spouse and 300,000 shares that Mr. Kou has the right to acquire upon the exercise of options.
- (3) Represents 20,000 shares that Mr. Chen has the right to acquire within the next 60 days upon the exercise of options.
- (4) Represents 20,000 shares that Mr. Chung has the right to acquire within the next 60 days upon the exercise of options.
- (5) Represents 100,000 shares owned by Ms. Liu and 20,000 shares that Ms. Liu has the right to acquire within the next 60 days upon the exercise of options.
- (6) Represents 103,050 shares owned by Mr. Ho and 70,000 shares owned by his spouse and 20,000 shares that Mr. Ho has the right to acquire within the next 60 days upon the exercise of options.
- (7) Represents 714,394 shares owned by Mr. Wang and 20,000 shares that Mr. Wang has the right to acquire within the next 60 days upon the exercise of options.
- (8) Represents 140,000 shares owned by Mr. Chen, 5,725 shares owned by his spouse and 30,000 shares that Mr. Chen has the right to acquire within the next 60 days upon the exercise of options.
- (9) Represents 140,000 shares owned by Mr. Chang and 56,333 shares that Mr. Chang has the right to acquire within the next 60 days upon the exercise of options.
- (10) Represents 3,521,422 ADSs, each representing four ordinary shares, based on the Schedule 13G/A filing with the U.S. Securities and Exchange Commission on February 14, 2007.

**ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**

**Major Shareholders**

As of June 20, 2007, there were 131,177,358 of our ordinary shares issued and outstanding. The Bank of New York, the depository under our ADS deposit agreement, has advised us that as of June 20, 2007, we had 31,075,006 ADSs, representing 124,300,024 ordinary shares.

The table in Item 6 above includes information known to us regarding those shareholders that beneficially own 5% or more of our ordinary shares. To our knowledge, we are not owned or controlled, directly or indirectly, by another corporation, by any foreign government or by any other natural or legal persons, severally or jointly. We are not aware of any arrangement which may at a later date result in a change of control of our company.

No holder of our ordinary shares has preferential voting rights.

**Related Party Transactions**

There were no related party transactions since the beginning of fiscal year 2006 through the date of this annual report.

**ITEM 8. FINANCIAL INFORMATION**

**Consolidated Financial Statements**

See “Item 18. Financial Statements” and pages F-1 through F-29 of this annual report.

**Legal Proceedings**

On January 2, 2003, O2Micro International Limited, or O2Micro, a Cayman Islands company, filed an action for a preliminary injunction against SMI Taiwan with the Taiwan Hsinchu District Court. The request for such preliminary injunction alleged that SMI Taiwan produced and sold products with embedded digital sound effect control chips that infringed O2Micro’s patent, patent registered number 130953, in Taiwan and asked for an order prohibiting SMI Taiwan from manufacturing and selling certain products that allegedly infringe O2Micro’s patent in Taiwan. On February 6, 2003, SMI Taiwan filed an action for a preliminary injunction against O2Micro denying such allegations and requesting O2Micro not to interfere with SMI Taiwan’s distribution, manufacturing and business operations in relation to the relevant products. A court-appointed appraiser completed a report on December 16, 2004 stating that SMI Taiwan’s products raised in the case do not infringe O2Micro’s patent. The appraiser’s report was submitted to the court. O2Micro’ application for a preliminary injunction was thus dismissed and O2Micro appealed this case to the Taiwan High Court on November 28, 2005.

On January 14, 2004, O2Micro filed for a preliminary injunction against SMI Taiwan and Microstar, a Taiwan customer of SMI Taiwan with the Taiwan Panchiao District Court. The request for injunctive relief asked for an order prohibiting SMI Taiwan and Microstar from designing, manufacturing, advertising and selling certain products that allegedly infringe O2Micro’s patent, patent registered number 178290, in Taiwan. On May 20, 2004, the Taiwan Panchiao District Court issued a preliminary injunctive order prohibiting SMI Taiwan and Microstar from designing, manufacturing, advertising and selling certain products that allegedly infringe O2Micro’s patent in Taiwan. SMI Taiwan appealed this case to the Taiwan High Court. The Taiwan High Court rejected the appeal on March 10, 2005, and SMI Taiwan appealed to the Taiwan Supreme Court. On November 10, 2005, the Taiwan Supreme Court vacated the Taiwan High Court Ruling and the case was remanded for further proceedings. The enforcement of such preliminary injunctive order has been withdrawn upon the deposit with the court by SMI Taiwan of NT\$11,506 thousand (US\$353 thousand).

## [Table of Contents](#)

On February 3, 2004, O2Micro filed an application for a provisional seizure of NT\$15 million against SMI Taiwan with the Taiwan Hsinchu District Court. The application alleged that SMI Taiwan infringed O2Micro's patent, patent registered number 130953, in Taiwan. The Taiwan Hsinchu District Court issued a provisional seizure order and attached some of SMI Taiwan's assets. Upon placing a deposit of NT\$15 million, the Taiwan Hsinchu District Court has released the enforcement of the provisional seizure order.

On September 24, 2004, O2Micro filed an action against SMI Taiwan with the Taiwan Hsinchu District Court. The complaint alleges that SMI Taiwan infringed O2Micro's patent, Taiwan patent registered number 130953, and O2Micro has requested SMI Taiwan to cease and desist the tortious act and a preliminary compensation in the amount of NT\$3 million (US\$92,000). On February 9, 2007, SMI Taiwan and O2Micro agreed to withdraw this case, as well as all the above-mentioned claims and application. As a result of this agreement, the management of SMI believes this case will not adversely affect SMI's operations or financial condition.

On May 1, 2005, SMI Taiwan incurred a loss on inventory in the possession of subcontractor, Advanced Semiconductor Engineering Inc., or ASE, due to fire. SMI Taiwan is currently in the claims process with ASE for an amount exceeding the book value of loss inventory. After consultation with the Company's outside legal counsel, the Company believes it is highly probable for the Company to receive reimbursement for the lost inventory at full book value, and the Company subsequently recorded NT\$41,226 thousand (US\$1.3 million) of inventory loss, offset by NT\$41,226 thousand (US\$1.3million) of fire loss reimbursement, resulting in zero impact to the earnings for the period. In connection with the inventory loss, the Company also recorded NT\$8,122 thousand (US\$249,000) under non-operating expenses for amounts paid to certain customers for delays in shipment caused by the fire.

On December 12, 2005, SMI Taiwan filed an action against ASE with the Taiwan Taoyuan District Court. SMI Taiwan alleges that ASE destroyed the wafer which SMI Taiwan had consigned to ASE with the OEM Agreement between SMI and ASE, and that ASE should pay SMI Taiwan a sum of NT\$77,218 thousand (US\$2.4 million) for damages. The Taiwan Taoyuan District Court is currently conducting preparatory proceeding.

Our management currently believes that the legal proceedings described above, individually or in the aggregate, will not have a material adverse effect on our financial position or operating results. The litigation and other claims noted above, however, are subject to inherent uncertainties and management's view of these matters may change in the future.

## **ITEM 9. THE OFFER AND LISTING**

### **Market and Share Price Information**

Our ADSs, each representing four of our ordinary shares, have been listed on Nasdaq since June 30, 2005. Our ADSs trade under the symbol "SIMO." The Nasdaq Global Market is the principal trading market for our ADSs, which are not listed on any other exchanges in or outside the United States.

The high and low sales prices of our ADSs on Nasdaq since listing are as follows:

	Price per ADS (US\$)	
	High	Low
<b>Annual:</b>		
2005 (beginning June 30, 2005)	16.32	8.75
2006	18.22	11.03
<b>Quarterly:</b>		
Third Quarter, 2005	16.32	8.75
Fourth Quarter, 2005	16.10	11.50
First Quarter, 2006	17.45	11.03
Second Quarter, 2006	15.86	11.50
Third Quarter, 2006	17.10	12.11
Fourth Quarter, 2006	18.22	14.41
First Quarter, 2007	27.28	15.60
<b>Monthly</b>		
December 2006	16.50	15.37
January 2007	19.19	15.60
February 2007	22.80	18.34
March 2007	27.28	19.45
April 2007	26.85	20.26
May 2007	24.48	19.92
June 2007 (through June 29)	26.38	22.02

## ITEM 10. ADDITIONAL INFORMATION

### Memorandum and Articles of Association

The information called for by Item 10B (“Memorandum and Articles of Association”) is incorporated by reference to the information under the heading “Description of Share Capital” in our Registration Statement on Form F-1, as amended (Registration Number 333-125673), as filed with the SEC on June 5, 2005.

### Material Contracts

We have not entered into any material contracts within the past two fiscal years other than in the ordinary course of business, other than those described in Item 4: “Information on the Company” or elsewhere in this annual report.

## Taxation

### United States Federal Income Taxation

The following discussion summarizes certain U.S. federal income tax consequences to a U.S. Holder, as defined below, who purchases our ADSs and ordinary shares. This discussion assumes that investors will hold their ADSs or ordinary shares as capital assets (generally, property held for investment). This discussion does not discuss all aspects of U.S. federal income taxation which may be important to particular investors in light of their individual circumstances, including investors subject to special taxation, such as:

- banks;
- dealers in securities or currencies; financial institutions; insurance companies; tax-exempt organizations;
- persons holding ADSs or ordinary shares as part of hedging, conversion, constructive sale, straddle or other integrated transactions;

## [Table of Contents](#)

- traders in securities that have elected the mark-to-market method of accounting;
- persons who own 10% or more of our ADSs or shares;
- U.S. persons whose “functional currency” is not the U.S. dollar; or
- Non-U.S. Holders (as defined below).

This discussion is based in part on representations by the depositary and assumes that each obligation under the deposit agreement and any related agreement will be performed in accordance with its terms. Furthermore, the discussion below is based upon the provisions of the Internal Revenue Code of 1986, as amended, or the Code, and U.S. Treasury regulations, rulings and judicial decisions thereunder as of the date hereof. Such authorities are subject to change, possibly on a retroactive basis, which may result in U.S. federal income tax consequences different from those discussed below. This discussion does not attempt to address the consequences to holders of shares or ADSs who acquired their shares or ADSs through the exercise of an employee stock option or otherwise as compensation or through a tax-qualified retirement plan.

A U.S. Holder considering an investment in our ADSs or ordinary shares is urged to consult its tax advisor concerning the U.S. federal, state, local and non-U.S. income and other tax consequences.

A U.S. Holder is a beneficial owner of ADSs or ordinary shares that is a U.S. person. A U.S. person is:

- a citizen or resident individual of the United States;
- a corporation or other entity taxable as a corporation created or organized in or under the laws of the United States, any state thereof, or the District of Columbia;
- an estate the income of which is subject to U.S. federal income taxation, regardless of its source; or
- a trust if it is subject to the primary supervision of a court within the United States and one or more U.S. persons have the authority to control all substantial decisions of the trust or has a valid election in effect under applicable U.S. Treasury regulations to be treated as a U.S. person.

A beneficial owner of ADSs or ordinary shares that is not a U.S. Holder is referred to herein as a “Non-U.S. Holder.”

If a partnership or limited liability company treated as a partnership for U.S. federal income tax purposes holds ADSs or ordinary shares, the tax treatment of a partner or member will generally depend on the status of the partner or member and the activities of the partnership or such limited liability company. A partner of a partnership or a member of such a limited liability company holding ADSs or ordinary shares is urged to consult its tax advisors regarding an investment in our ADSs or ordinary shares.

ADSs. In general, for U.S. federal income tax purposes, a U.S. Holder of ADSs will be treated as the owner of the underlying ordinary shares that are represented by such ADSs. Deposits and withdrawals of ordinary shares in exchange for ADSs will not be subject to U.S. federal income taxation.

*Distributions on ADSs or ordinary shares.* Unless the passive foreign investment company rules, as discussed below, apply, the gross amount of the distributions in respect of the ADSs or ordinary shares will be subject to tax as dividend income to the extent of our current and accumulated earnings and profits, as determined under U.S. federal income tax principles. Subject to certain limitations, dividends paid to non-corporate U.S. Holders, including individuals, may be eligible for a reduced rate of taxation if we are deemed to be a “qualified foreign corporation” for U.S. federal income tax purposes and provided that such holder satisfies certain holding period requirements with respect to the ownership of our ADSs, or ordinary shares. Subject to the exceptions discussed below, a qualified foreign corporation includes:

- a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States that includes an exchange of information program; and

## [Table of Contents](#)

- a foreign corporation if its stock with respect to which a dividend is paid or its ADSs backed by such stock are readily tradable on an established securities market within the United States.

The Cayman Islands does not currently have comprehensive income tax treaty with the United States. A foreign corporation (even if it is described above) does not constitute a qualified foreign corporation if, for the taxable year in which the dividend is paid or the preceding taxable year, the foreign corporation is or was a passive foreign investment company. Although we believe that we will be a qualified foreign corporation because the ADSs will be traded on an established U.S. securities market, no assurance can be given in this regard. In addition, our status as a qualified foreign corporation may change. A U.S. Holder that exchanges its ADSs for ordinary shares may not be eligible for the reduced rate of taxation on dividends if the ordinary shares are not deemed to be readily tradable on an established securities market within the United States.

Dividends will be includable in a U.S. Holder's gross income on the date actually or constructively received by the depository, in the case of ADSs or, in the case of ordinary shares, by such U.S. Holder. These dividends will not be eligible for the dividends-received deduction generally allowed to U.S. corporations in respect of dividends received from other U.S. corporations.

To the extent we pay dividends on the ADSs or ordinary shares in a currency other than the U.S. dollar, the U.S. dollar value of such dividends should be calculated by reference to the exchange rate prevailing on the date of actual or constructive receipt of the dividend, regardless of whether the foreign currency is converted into U.S. dollars at that time. If the foreign currency is converted into U.S. dollars on the date of actual or constructive receipt of such dividends, the tax basis of the U.S. Holder in such foreign currency will be equal to its U.S. dollar value on that date and, as a result, the U.S. Holder generally should not be required to recognize any foreign currency exchange gain or loss. Dividends paid in respect of the ADSs or ordinary shares generally will be treated as income from sources outside the United States.

To the extent that the amount of any distribution exceeds our current and accumulated earnings and profits, the distribution will first be treated as a tax-free return of capital, causing a reduction in the adjusted basis of the ADSs or ordinary shares, and the balance in excess of adjusted basis will be taxed as capital gain.

*Sale, exchange or other disposition of ADSs or ordinary shares.* Unless the passive foreign investment company rules, as discussed below, apply, upon the sale, exchange or other disposition of ADSs or ordinary shares a U.S. Holder generally will recognize capital gain or loss equal to the difference between the amount realized upon the sale, exchange or other disposition and the adjusted tax basis of the U.S. Holder in the ADSs or ordinary shares. The capital gain or loss generally will be long-term capital gain or loss if, at the time of sale, exchange or other disposition, the U.S. Holder has held the ADS or ordinary share for more than one year. Net long-term capital gains of non-corporate U.S. Holders, including individuals, are eligible for reduced rates of taxation. The deductibility of capital losses is subject to limitations. Any gain or loss that a U.S. Holder recognizes generally will be treated as gain or loss from sources within the United States for U.S. foreign tax credit limitation purposes.

*Passive foreign investment company rules.* In general, we will be classified as a passive foreign investment company for any taxable year in which either (a) at least 75% of our gross income is passive income or (b) at least 50% of the value (determined on the basis of a quarterly average) of our assets is attributable to assets that produce or are held for the production of passive income. For this purpose, passive income generally includes dividends, interest, royalties, rents (other than rents and royalties derived in the active conduct of a trade or business and not derived from a related person), annuities and gains from assets that produce passive income. If we own directly or indirectly at least 25% by value of the equity shares of another corporation, we will be treated for purposes of the passive foreign investment company tests as owning a proportionate share of the assets of the other corporation, and as receiving directly a proportionate share of the other corporation's income.

## [Table of Contents](#)

We believe, based on our present and projected composition of our income and valuation of our assets, that we are not currently and, should not in the future, be classified as a passive foreign investment company for U.S. federal income tax purposes, although no assurance can be given in this regard. Whether we are a passive foreign investment company for any particular taxable year is determined on an annual basis and will depend on the composition of our income and assets, including goodwill. The calculation of goodwill will be based, in part, on the then market value of our capital stock, which is subject to fluctuation. In addition, the composition of our income and assets will be affected by how we spend the cash we raise in this offering. Accordingly, there can be no assurance that we will not be classified as a passive foreign investment company in the current or any future taxable year.

If we are a passive foreign investment company for any taxable year during which a U.S. Holder has an equity interest in our company, unless the U.S. Holder makes a mark-to-market election as discussed below, such U.S. Holder will be subject to special tax rules in any future taxable year regardless of whether we are classified as a passive foreign investment company in such future years with respect to (a) “excess distributions” and (b) gain from the disposition of stock. Excess distributions are defined generally as the excess of the amount received with respect to the equity interests in the taxable year over 125% of the average annual distributions received in the shorter of either the three previous years or a U.S. Holder’s holding period before the taxable year and must be allocated ratably to each day of the U.S. Holder’s holding period. The amount allocated to the current taxable year or any year before we became a passive foreign investment company will be included as ordinary income in a U.S. Holder’s gross income for that year. The amount allocated to other prior taxable years will be taxed as ordinary income at the highest rate in effect for a U.S. Holder in that prior year and the tax is subject to an interest charge at the rate applicable to deficiencies in income taxes. The entire amount of any gain realized upon the sale or other disposition of the equity interests will be treated as an excess distribution made in the year of sale or other disposition and as a consequence will be treated as ordinary income and, to the extent allocated to years prior to the year of sale or disposition with respect to which we were a passive foreign investment company, will be subject to the interest charge described above.

In certain circumstances, instead of being subject to the excess distribution rules discussed above, a U.S. Holder may make an election to include gain on the ADSs or ordinary shares of a passive foreign investment company as ordinary income under a mark-to-market method, provided that the ADSs or ordinary shares are regularly traded on a qualified exchange. Under current law, the mark-to-market election is only available for ADSs or ordinary shares that are regularly traded within the meaning of U.S. Treasury regulations on certain designated U.S. exchanges and foreign exchanges that meet trading, listing, financial disclosure and other requirements to be treated as a qualified exchange under applicable U.S. Treasury regulations. The Nasdaq National Market is a qualified exchange. The ordinary shares may not be eligible for mark-to-market treatment under the foregoing rule even if the ADSs otherwise satisfy the applicable requirement.

If a U.S. Holder makes a mark-to-market election, the U.S. Holder will include each year as ordinary income, rather than capital gain, the excess, if any, of the fair market value of the U.S. Holder’s ADSs or ordinary shares at the end of the taxable year over such U.S. Holder’s adjusted basis in the ADSs (or ordinary shares, if applicable) and will be permitted an ordinary loss in respect of the excess, if any, of the adjusted basis of these ADSs or ordinary shares over their fair market value at the end of the taxable year, but only to the extent of the net amount previously included in income as a result of the mark-to-market election. A U.S. Holder’s basis in the ADSs or ordinary shares will be adjusted to reflect any such income or loss amounts. Any gain or loss on the sale of the ADSs or ordinary shares will be ordinary income or loss, except that this loss will be ordinary loss only to the extent of the previously included net mark-to-market gain.

If a U.S. Holder owns ADSs or ordinary shares during any year that we are a passive foreign investment company, the U.S. Holder must file Internal Revenue Service Form 8621.

A U.S. Holder is urged to consult its tax advisor concerning the U.S. federal income tax consequences of an investment in our ADSs or ordinary shares if we are or become a passive foreign investment company, including the possibility of making a market-to-market election.



## [Table of Contents](#)

### **Cayman Islands Taxation**

The Cayman Islands currently levy no taxes on individuals or corporations based upon profits, income, gains or appreciation and there is no taxation in the nature of inheritance tax or estate duty. There are no other taxes likely to be material to our company levied by the Government of the Cayman Islands except for stamp duties that may be applicable on instruments executed in, or after execution brought within the jurisdiction of, the Cayman Islands. The Cayman Islands are not party to any double taxation treaties. There are no exchange control regulations or currency restrictions in the Cayman Islands.

We have, pursuant to Section 6 of the Tax Concessions Law (1999 Revision) of the Cayman Islands, obtained an undertaking from the Governor-in-Council that:

- no law which is enacted in the Cayman Islands imposing any tax to be levied on profits or income or gains or appreciation applies to us or our operations; and
- the aforesaid tax or any tax in the nature of estate duty or inheritance tax are not payable on our ordinary shares, debentures or other obligations.

The undertaking that we have obtained is for a period of 20 years from March 1, 2005.

### **Documents on Display**

We have previously filed with the SEC our registration statement on Form F-1 and prospectus under Securities Act with respect to our ADSs.

We are subject to the periodic reporting and other informational requirements of the U.S. Securities Exchange Act of 1934, or the Exchange Act. Under the Exchange Act, we are required to file reports and other information with the SEC. Specifically, we are required to file annually a Form 20-F no later than six months after the close of each fiscal year, which is December 31. As a foreign private issuer, we are exempt from the rules under the Exchange Act prescribing the furnishing and content of quarterly reports and proxy statements, and our officers, directors, and principal shareholders are exempt from the reporting and short-swing profit recovery provisions of Section 16 of the Exchange Act.

Copies of reports and other information, when so filed, may be inspected without charge and may be obtained at prescribed rates at the public reference facilities maintained by the Securities and Exchange Commission at the SEC's public reference room in Washington D.C. at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. You can request copies of these documents upon payment of a duplicating fee, by writing to the SEC. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference rooms. The SEC also maintains a Website at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding registrants that make electronic filings with the SEC using its EDGAR system.

### **ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

*Interest rate risk.* Our exposure to interest risk for changes in interest rates is limited to the interest income generated by our cash deposited with banks and short-term investments maintained in bond funds. We do not believe that a 1% change in interest rates would have a significant impact on our operations.

*Foreign currency risk.* Substantial portions of our net sales and expenses are denominated in currencies other than the NT dollar. As of Dec 31, 2006, more than 76% of our accounts payable and payables were denominated in currencies other than the NT dollar, primarily in U.S. dollars. More than 43% of our accounts receivable were denominated in currencies other than the NT dollar, mainly in U.S. dollars. In 2006, all of our sales were quoted in U.S. dollars and approximately 56% of our sales quotes were invoiced in NT dollars using the opening average exchange rate on the day of the sales invoice. In 2006, approximately 87% of our cost of

## [Table of Contents](#)

sales and operating expenses were denominated in U.S. dollars. Hypothetically, if the U.S. dollar value had increased or decreased by 10% against the NT dollar in 2006, our operating income would have increased or decreased, as the case may be, by approximately 9%, assuming all other factors remain constant. We anticipate that we will continue to quote substantially all of our sales in U.S. dollars. We do not believe that we have a material currency risk with regard to the Japanese Yen, Euros, Renminbi, or South Korean Won. We believe any potential adverse foreign exchange impacts on our operating assets may be offset by a potential favorable foreign exchange impact on our operating liabilities. We do not utilize foreign exchange derivatives contracts to protect against the volatility changes in foreign exchange rates. See “Risk Factors—Fluctuations in exchange rates could result in foreign exchange losses.”

### **ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

Not applicable.

## **PART II**

### **ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES**

Not applicable.

### **ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND THE USE OF PROCEEDS**

The following discussion relates to the initial public offering our ADSs by us and certain selling shareholders, pursuant to a registration statement on Form F-1 (File No. 333-125673), which was completed on July 5, 2005. The registration statement was declared effective by the SEC on June 29, 2005.

We received net proceeds (after deducting underwriting discounts and commissions and other expenses related to the offering) of approximately US\$41.1 million from the offering 4,300,000 ADSs, representing 17,200,000 ordinary shares. The selling shareholders received net proceeds (after deducting underwriting discounts and commissions and other expenses related to the offering) of approximately US\$23.4 million from the offering 2,400,000 ADSs, representing 9,600,000 ordinary shares. We did not receive any proceeds from the sale of our ADSs by the selling shareholders

The expenses incurred by us in connection with the issuance and distribution of the registered securities totaled US\$5.8 million, including US\$4.9 million for underwriting discounts and commissions and US\$0.9 million for other expenses. None of the transaction expenses included payments to our directors, executive officers, persons owning 10% or more of our equity securities or our affiliates. Deutsche Bank Securities, WR Hambrecht + Co, and Needham & Company LLC were the underwriters for the offering.

From July 5, 2005 through June 29, 2007, we have used the entire net proceeds from our initial public offering, together with cash flows from operations, as follows:

- research and development expenditure of NT\$998 million (US\$30.6 million)
- invested US\$3.7 million in our operation in China
- partial payment for our US\$90 million acquisition of FCI, of which US\$50 million was payment in cash

### **ITEM 15. CONTROLS AND PROCEDURES**

See Item 15T below.

**ITEM 15T. CONTROLS AND PROCEDURES**

*Disclosure Controls and Procedures*

We performed an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2006. Disclosure controls and procedures are designed to ensure that the material financial and non-financial information required to be disclosed in this annual report on Form 20-F and filed with the SEC is recorded, processed, summarized and reported in a timely manner. The evaluation was performed with the participation of our key corporate senior management, and under the supervision of our Chief Financial Officer, or CFO, Riyadh Lai, and our President and Chief Executive Officer, or CEO, Wallace Kou. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable, rather than absolute, assurances of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the foregoing, our management, including our CEO and CFO, concluded that our disclosure controls and procedures were effective.

*Management's Report on Internal Control over Financial Reporting*

Our management, including our chief executive officer and chief financial officer, is responsible for establishing and maintaining adequate internal control over financial reporting, as defined under Exchange Act Rules 13a-15(f) and 15d-15(f). Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States. Internal control over financial reporting includes those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets, (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that the receipts and expenditures are being made only in accordance with appropriate authorizations; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

Our management assessed the effectiveness of our internal control over financial reporting as of the end of the period covered by this annual report based on the criteria set forth in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Their assessment included an evaluation of the design of our internal control over financial reporting and testing of the operational effectiveness of our internal control over financial reporting. Based on that assessment, our management concluded that as of December 31, 2006 the company's internal control over financial reporting was effective.

While our management concluded that our internal control over financial reporting was effective, we are in the process developing and implementing additional internal control policies and procedures, including an anonymous whistleblower reporting system, more comprehensive internal audit procedures and additional anti-fraud controls. Management expects these and other additional internal control policies and procedures to be implemented prior to the end of our 2007 fiscal year.

This annual report does not include an attestation report of our independent registered public accounting firm regarding internal control over financial report. Management's report was not subject to attestation by our independent registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management's report in this annual report.

*Changes Internal Control over Financial Reporting*

There have been no changes in our internal control over financial reporting subsequent to the date of our most recent evaluation that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## [Table of Contents](#)

### ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT

Our board of directors has determined that Mr. Tsung-Ming Chung, the Chairman of our audit committee, is a “financial expert” under Nasdaq’s Marketplace Rules.

### ITEM 16B. CODE OF ETHICS

Our board of directors has adopted a code of business conduct and ethics applicable to every employee of our company, including our CEO and our CFO, consistent with the requirements of the Nasdaq Global Market. A copy of our code of ethics has been filed with the SEC as Exhibit 11.1 to our annual report on Form 20-F filed on June 30, 2006.

### ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES

Deloitte & Touche has acted as the independent public accountants of our company and its subsidiaries for 2005 and 2006. The following table sets forth the aggregate fees by categories specified below in connection with certain professional services rendered by Deloitte & Touche for the periods indicated.

(in thousands)	2005	2006
	NT\$	NT\$
Audit Fees <sup>(1)</sup>	7,152	7,600
Audit-Related Fees <sup>(2)</sup>	—	2,000
Tax Fees <sup>(3)</sup>	613	1,500
All Other Fees <sup>(4)</sup>	—	—
Total	7,765	11,100

- (1) *Audit Fees.* This category includes the audit and review of our annual financial statements and services that are normally provided by the independent auditors in connection with regulatory filings or engagements, consultations provided on audit and accounting matters that arise during, or as a result of, the audits or the reviews of interim financial statements, audit procedures related to reviews of offering documents, registration statements and issuance of comfort letters.
- (2) *Audit-Related Fees.* This category consists of assurance and related services by Deloitte & Touche that are reasonably related to the performance of the audit or review of our financial statements and are not reported above under “Audit Fees.” The services for the fees disclosed under this category include consultation with respect to adoption of new requirements for reporting on internal control over financial reporting.
- (3) *Tax Fees.* This category consists of professional services rendered by Deloitte & Touche for tax compliance and tax advice. The services for the fees disclosed in this category include tax return preparation and technical tax advice.
- (4) *All other fees.* Deloitte & Touche did not provide any services under this category in 2005 or 2006.

Our audit committee is responsible for the retention of our independent registered public accounting firm, which currently is Deloitte & Touche. Our audit committee has adopted its own rules of procedure, in the form of an audit committee charter. The audit committee’s rules of procedure provide for a process with respect to the prior approval of all non-audit services to be performed by our independent auditors. Our audit committee reports to our board of directors regarding the scope and results of our annual audits, compliance with our accounting and financial policies and management’s procedures and policies related to the adequacy of our internal accounting controls.

In 2006 our audit committee approved all of the audit services provided by Deloitte & Touche, and the other services provided by Deloitte & Touche.

## [Table of Contents](#)

### **ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

Not applicable.

### **ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS**

Not applicable.

## **PART III**

### **ITEM 17. FINANCIAL STATEMENTS**

Not applicable.

### **ITEM 18. FINANCIAL STATEMENTS**

Our consolidated financial statements are included in this annual report at pages F-2 through F-26.

### **ITEM 19. EXHIBITS**

<b>Exhibit Number</b>	<b>Description</b>
1.1	Memorandum of Association of the Registrant (incorporated by reference to Exhibit 3.1 to the company's Registration Statement on Form F-1 (file no. 333-125673) filed with the Securities and Exchange Commission on June 9, 2005).
1.2	Articles of Association of the Registrant (incorporated by reference to Exhibit 3.2 to the company's Registration Statement on Form F-1 (file no. 333-125673) filed with the Securities and Exchange Commission on June 9, 2005).
2.1	Specimen of American Depositary Receipt (incorporated by reference to Exhibit 3.3 to the company's Registration Statement on Form F-1 (file no. 333-125673) filed with the Securities and Exchange Commission on June 9, 2005).
2.2	Form of Deposit Agreement (incorporated by reference to Exhibit 4.2 to the company's Registration Statement on Form F-1 (file no. 333-125673) filed with the Securities and Exchange Commission on June 9, 2005).
2.3*	Amended and Restated Silicon Motion Technology Corporation 2005 Equity Incentive Plan.
4.1	Lease Agreement between Silicon Motion, Inc. (Taiwan) and Fang Shinn Industrial Co., Ltd. dated May 4, 2004 (incorporated by reference to Exhibit 10.1 to the company's Registration Statement on Form F-1 (file no. 333-125673) filed with the Securities and Exchange Commission on June 9, 2005).
4.2	Lease Agreement between Silicon Motion, Inc. (Taiwan) and TaiHsing Printing and Binding Co., Ltd dated February 23, 2005 (incorporated by reference to Exhibit 10.2 to the company's Registration Statement on Form F-1 (file no. 333-125673) filed with the Securities and Exchange Commission on June 9, 2005).
4.3	Lease Agreement between Silicon Motion, Inc. (Taiwan) and Winsome Development Inc. dated November 27, 2003 (incorporated by reference to Exhibit 10.3 to the company's Registration Statement on Form F-1 (file no. 333-125673) filed with the Securities and Exchange Commission on June 9, 2005).
4.4	Lease Agreement between Silicon Motion, Inc. (Taiwan) and Richtek Technology Corp. dated February 4, 2005 (incorporated by reference to Exhibit 10.4 to the company's Registration Statement on Form F-1 (file no. 333-125673) filed with the Securities and Exchange Commission on June 9, 2005).

## Table of Contents

- 4.5 Lease Agreement between Silicon Motion, Inc. (California) and Orchard Investment Company Number 205 dated January 21, 2004 (incorporated by reference to Exhibit 10.5 to the company's Registration Statement on Form F-1 (file no. 333-125673) filed with the Securities and Exchange Commission on June 9, 2005).
- 4.6 Bank Line of Credit Agreement between Silicon Motion, Inc. (Taiwan) and Chinatrust Commercial Bank Co., Ltd. dated November 25, 2004 (incorporated by reference to Exhibit 10.6 to the company's Registration Statement on Form F-1 (file no. 333-125673) filed with the Securities and Exchange Commission on June 9, 2005).
- 4.7 Financial Transaction Agreement between Silicon Motion, Inc. (Taiwan) and Chinatrust Commercial Bank Co., Ltd. dated November 25, 2004 (incorporated by reference to Exhibit 10.7 to the company's Registration Statement on Form F-1 (file no. 333-125673) filed with the Securities and Exchange Commission on June 9, 2005).
- 4.8 Specific Clause Agreement between Silicon Motion, Inc. (Taiwan) and Chinatrust Commercial Bank Co., Ltd. dated November 25, 2004 (incorporated by reference to Exhibit 10.8 to the company's Registration Statement on Form F-1 (file no. 333-125673) filed with the Securities and Exchange Commission on June 9, 2005).
- 4.11 Purchase and Supply Agreement between Lexar Media, Inc. and Silicon Motion Technology Corporation, dated September 1, 2005 (incorporated by reference to Exhibit 4.11 to the Company's Annual Report on Form 20-F filed with the Securities and Exchange Commission on June 30, 2006).
- 4.12\* Share Purchase Agreement dated as of April 18, 2007 among Silicon Motion Technology Corporation, Lake Tahoe Investment Corporation, Future Communications IC, Inc. ("FCI") and Kwang Jun Yun and the shareholders of FCI.
- 8.1 List of Subsidiaries (incorporated by reference to Exhibit 21.1 to the company's Registration Statement on Form F-1 (file no. 333-125673) filed with the Securities and Exchange Commission on June 9, 2005).
- 11.1 Code of Ethics (incorporated by reference to Exhibit 11.1 to the company's Annual Report on Form 20-F filed with the Securities and Exchange Commission on June 30, 2006).
- 12.1\* Certification of Chief Executive Officer Required by Rule 13a-14(a).
- 12.2\* Certification of Chief Financial Officer Required by Rule 13a-14(a).
- 13.1\* Certification of Chief Executive Officer and Chief Financial Officer required by Rule 13a-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code.
- 23.1\* Consent of Deloitte & Touche

---

\* Filed herewith.



[Table of Contents](#)

**SILICON MOTION TECHNOLOGY CORPORATION AND SUBSIDIARIES**  
**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

<a href="#">Report of Independent Registered Public Accounting Firm</a>	F-2
<a href="#">Consolidated Balance Sheets as of December 31, 2005 and 2006</a>	F-3
<a href="#">Consolidated Statements of Income for the Years Ended December 31, 2004, 2005 and 2006</a>	F-4
<a href="#">Consolidated Statements of Changes in Shareholders' Equity and Comprehensive Income (Loss) for the Years Ended December 31, 2004, 2005 and 2006</a>	F-5
<a href="#">Consolidated Statements of Cash Flows for the Years Ended December 31, 2004, 2005 and 2006</a>	F-6
<a href="#">Notes to the Consolidated Financial Statements</a>	F-9



**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Shareholders  
Silicon Motion Technology Corporation

We have audited the accompanying consolidated balance sheets of Silicon Motion Technology Corporation and its subsidiaries ( the “Company”) as of December 31, 2005 and 2006 and the related consolidated statements of income, changes in shareholders’ equity and comprehensive income (loss) and cash flows for the years ended December 31, 2004, 2005 and 2006, all expressed in New Taiwan dollars. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2005 and 2006, and the results of their operations and their cash flows for the years ended December 31, 2004, 2005 and 2006, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 2 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 123 (R), “Share-Based Payment” on January 1, 2006.

Our audits also comprehended the translation of New Taiwan dollar amounts into U.S. dollar amounts and, in our opinion, such translation has been made in conformity with the basis stated in Note 3 to the consolidated financial statements. Such U.S. dollar amounts are presented for the convenience of the readers.

/s/ Deloitte & Touche  
Taipei, Taiwan  
Republic of China

April 30, 2007

**SILICON MOTION TECHNOLOGY CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(In Thousands, Except Shares and Par Value)**

	December 31		
	2005 NT\$	2006 NT\$	US\$ (Note 3)
<b>ASSETS</b>			
Current Assets			
Cash and cash equivalents	1,581,993	1,808,042	55,478
Short-term investments	1,157,955	1,458,847	44,764
Notes and accounts receivable, net	728,279	1,018,141	31,241
Inventories, net	278,528	427,116	13,106
Refundable deposits	60,000	65,000	1,994
Deferred income tax assets, net	48,858	103,603	3,179
Prepaid expenses and other current assets	67,782	68,455	2,100
Total current assets	<u>3,923,395</u>	<u>4,949,204</u>	<u>151,862</u>
Long-term investments	15,954	170,942	5,245
Property and equipment, net	83,734	319,356	9,799
Deferred income tax assets, net	16,282	47,241	1,450
Other assets	6,326	8,845	272
Other restricted assets	42,440	33,096	1,016
Total assets	<u>4,088,131</u>	<u>5,528,684</u>	<u>169,644</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
Current Liabilities			
Notes and accounts payable	318,978	525,218	16,117
Income tax payable	104,744	139,268	4,273
Accrued expenses and other current liabilities	207,632	294,016	9,022
Total current liabilities	<u>631,354</u>	<u>958,502</u>	<u>29,412</u>
Accrued pension cost	5,365	1,019	31
Other long-term liabilities	1,627	1,040	32
Total liabilities	<u>638,346</u>	<u>960,561</u>	<u>29,475</u>
Commitments and Contingencies ( Note 16)			
Shareholders' Equity			
Ordinary Shares at US\$ 0.01 par value per share			
Authorized: 500,000,000 shares			
Issued and outstanding: 122,612,000 shares at December 31, 2005 and 123,780,268 shares at December 31, 2006	38,659	39,031	1,198
Additional paid-in capital	3,348,236	3,522,094	108,073
Accumulated other comprehensive income	49,157	45,774	1,404
Retained earnings	13,733	961,224	29,494
Total shareholders' equity	<u>3,449,785</u>	<u>4,568,123</u>	<u>140,169</u>
Total liabilities and shareholders' equity	<u>4,088,131</u>	<u>5,528,684</u>	<u>169,644</u>

The accompanying notes are an integral part of the consolidated financial statements.

(Concluded)

**SILICON MOTION TECHNOLOGY CORPORATION AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF INCOME**
**(In Thousands, Except Shares and Earnings Per Share)**

	Year Ended December 31			
	2004	2005	2006	US\$ (Note 3)
	NT\$	NT\$	NT\$	
NET SALES	2,166,727	2,686,492	3,460,459	106,182
COST OF SALES	1,274,410	1,342,749	1,612,019	49,464
GROSS PROFIT	<u>892,317</u>	<u>1,343,743</u>	<u>1,848,440</u>	<u>56,718</u>
OPERATING EXPENSES (INCOME)				
Research and development	238,485	373,548	502,225	15,410
Sales and marketing	141,136	157,278	200,526	6,153
General and administrative	103,303	129,141	219,395	6,732
Amortization of intangible assets	17,758	4,501	—	—
Impairment of intangible assets	11,718	—	—	—
Compensation to customers	—	8,122	—	—
Gain from settlement on litigation	—	—	(3,000)	(92)
Write-off of other receivable	—	—	40,039	1,229
Total operating expenses	<u>512,400</u>	<u>672,590</u>	<u>959,185</u>	<u>29,432</u>
OPERATING INCOME	<u>379,917</u>	<u>671,153</u>	<u>889,255</u>	<u>27,286</u>
NON-OPERATING INCOME (EXPENSES)				
Gain on sales of investments, net	10,135	12,799	17,857	548
Interest income	646	26,942	65,220	2,001
Foreign exchange gain (expense), net	13,719	1,811	(5,174)	(160)
Impairment of long-term investments	(4,053)	—	—	—
Interest expense	(169)	(46)	(33)	(1)
Other income, net	909	2,698	1,398	44
Total non-operating income	<u>21,187</u>	<u>44,204</u>	<u>79,268</u>	<u>2,432</u>
INCOME BEFORE INCOME TAX	401,104	715,357	968,523	29,718
INCOME TAX EXPENSE	133,101	42,055	21,032	645
NET INCOME	<u>268,003</u>	<u>673,302</u>	<u>947,491</u>	<u>29,073</u>
EARNINGS PER ORDINARY SHARE:				
Basic	<u>2.58</u>	<u>5.90</u>	<u>7.69</u>	<u>0.24</u>
Diluted	<u>2.58</u>	<u>5.80</u>	<u>7.55</u>	<u>0.23</u>
WEIGHTED AVERAGE ORDINARY SHARES OUTSTANDING				
Basic (Thousands)	<u>103,878</u>	<u>114,083</u>	<u>123,251</u>	<u>123,251</u>
Diluted (Thousands)	<u>103,878</u>	<u>116,015</u>	<u>125,488</u>	<u>125,488</u>
EARNINGS PER ADS (one ADS equals four ordinary shares) :				
Basic	<u>10.32</u>	<u>23.61</u>	<u>30.75</u>	<u>0.94</u>
Diluted	<u>10.32</u>	<u>23.21</u>	<u>30.20</u>	<u>0.93</u>
WEIGHTED AVERAGE ADS OUTSTANDING				
Basic (Thousands)	<u>25,970</u>	<u>28,521</u>	<u>30,813</u>	<u>30,813</u>
Diluted (Thousands)	<u>25,970</u>	<u>29,004</u>	<u>31,372</u>	<u>31,372</u>

The accompanying notes are an integral part of the consolidated financial statements.

(Concluded)

**SILICON MOTION TECHNOLOGY CORPORATION AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME (LOSS)**
**(In Thousands, Except Per Share Data)**

	Capital Stock				Additional Paid-in Capital NT\$	Accumulated Other Comprehensive Income (Loss) NT\$	Retained Earnings (Accumulated Deficit) NT\$	Total Shareholders' Equity NT\$
	Ordinary Share		Common Stock					
	Shares (thousands)	Amount NT\$	Shares (thousands)	Amount NT\$				
BALANCE, JANUARY 1, 2004	—	—	90,000	900,000	719,160	3,318	(513,887)	1,108,591
Net income	—	—	—	—	—	—	268,003	268,003
Net unrealized gains on available-for-sale securities	—	—	—	—	—	697	—	697
Foreign currency translation adjustments	—	—	—	—	—	(3,934)	—	(3,934)
Total comprehensive income								264,766
Stock dividends - 14.5%	—	—	13,050	130,500	283,185	—	(413,685)	—
Stock bonus to employees	—	—	2,362	23,620	51,256	—	—	74,876
BALANCE, DECEMBER 31, 2004	—	—	105,412	1,054,120	1,053,601	81	(659,569)	1,448,233
Net income	—	—	—	—	—	—	673,302	673,302
Net realized gains on available-for-sale securities	—	—	—	—	—	(697)	—	(697)
Foreign currency translation adjustments	—	—	—	—	—	49,773	—	49,773
Total comprehensive income	—	—	—	—	—	—	—	722,378
Issuance of ordinary shares in exchange for SMI common stock	105,412	33,215	(105,412)	(1,054,120)	1,020,905	—	—	—
Proceeds from initial public offering of ordinary shares	17,200	5,444	—	—	1,273,730	—	—	1,279,174
BALANCE, DECEMBER 31, 2005	122,612	38,659	—	—	3,348,236	49,157	13,733	3,449,785
Net income	—	—	—	—	—	—	947,491	947,491
Foreign currency translation adjustments	—	—	—	—	—	(5,483)	—	(5,483)
Total comprehensive income								942,008
Adjustment of proceeds from initial public offering of ordinary shares in 2005	—	—	—	—	21,796	—	—	21,796
Initial application of SFAS No. 158	—	—	—	—	—	2,100	—	2,100
Stock-based compensation expenses	—	—	—	—	85,699	—	—	85,699
Issuance of ordinary shares upon exercise of employee stock options	1,168	372	—	—	66,363	—	—	66,735
BALANCE, DECEMBER 31, 2006	123,780	39,031	—	—	3,522,094	45,774	961,224	4,568,123

(Continued)

[Table of Contents](#)

	Capital Stock				Additional Paid-in Capital US\$	Accumulated Other Comprehensive Income (Loss) US\$	Retained Earnings (Accumulated Deficit) US\$	Total Shareholders' Equity US\$
	Ordinary Share		Common Stock					
	Shares (thousands)	Amount US\$	Shares (thousands)	Amount US\$				
BALANCE, JANUARY 1, 2006	122,612	1,186	—	—	102,738	1,508	421	105,853
Net income	—	—	—	—	—	—	29,073	29,073
Foreign currency translation adjustments	—	—	—	—	—	(168)	—	(168)
Total comprehensive income								28,905
Adjustment of proceeds from initial public offering of ordinary shares in 2005	—	—	—	—	669	—	—	669
Initial application of SFAS No. 158	—	—	—	—	—	64	—	64
Stock-based compensation expenses	—	—	—	—	2,630	—	—	2,630
Issuance of ordinary shares upon exercise of employee stock options	1,168	12	—	—	2,036	—	—	2,048
BALANCE, DECEMBER 31, 2006	<u>123,780</u>	<u>1,198</u>	<u>—</u>	<u>—</u>	<u>108,073</u>	<u>1,404</u>	<u>29,494</u>	<u>140,169</u>

The accompanying notes are an integral part of the consolidated financial statements.

(Concluded)

## SILICON MOTION TECHNOLOGY CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

	Year Ended December 31			
	2004 NT\$	2005 NT\$	2006 NT\$	US\$ (Note 3)
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>				
Net income	268,003	673,302	947,491	29,073
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	21,734	23,906	35,596	1,092
Unrealized holding gain on marketable securities	—	—	(3)	—
Amortization of intangible assets	17,758	4,501	—	—
Impairment of intangible assets	11,718	—	—	—
Gain on sales of short-term investments	(10,135)	(12,799)	(17,857)	(548)
Impairment of long-term investments	4,053	—	—	—
Stock bonus to employees	51,256	—	—	—
Stock-based compensation	—	—	85,699	2,630
Loss on disposal of property and equipment	2,124	291	29	1
Deferred income taxes	54,464	(22,731)	(85,704)	(2,630)
Accrued pension cost	764	552	(2,247)	(69)
Deferred rent	96	(372)	(570)	(17)
Changes in operating assets and liabilities:				
Short-term investments	—	—	(283,032)	(8,685)
Notes and accounts receivable	(308,958)	(240,417)	(289,862)	(8,894)
Inventories	(353,621)	230,621	(148,588)	(4,559)
Prepaid expenses and other current assets	(15,764)	(37,735)	(195)	(6)
Notes and accounts payable	404,979	(226,840)	206,240	6,328
Accrued expenses and other current liabilities	8,099	120,118	115,242	3,536
Income tax payable	78,133	26,611	34,524	1,059
Net cash provided by operating activities	<u>234,703</u>	<u>539,008</u>	<u>596,763</u>	<u>18,311</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>				
Purchases of short-term investments	(2,646,924)	(8,350,343)	—	—
Sales of short-term investments	2,502,631	7,399,615	—	—
Acquisition of long-term investments	—	(12,812)	(155,090)	(4,759)
Purchase of property and equipment	(36,409)	(42,708)	(271,697)	(8,337)
Proceeds from disposal of property and equipment	476	402	429	13
Decrease (increase) in refundable deposits	(82,875)	(6,089)	1,348	42
Net cash used in investing activities	<u>(263,101)</u>	<u>(1,011,935)</u>	<u>(425,010)</u>	<u>(13,041)</u>

(Continued)

[Table of Contents](#)

	Year Ended December 31			
	2004	2005	2006	
	NT\$	NT\$	NT\$	US\$ (Note 3)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>				
Proceeds from issuance of ordinary shares upon exercise of employee stock options	—	—	38,133	1,170
Proceeds from initial public offering of ordinary shares	—	1,279,174	21,796	669
Repayment of other long-term liabilities	(3,081)	(306)	—	—
Net cash provided by (used in) financing activities	(3,081)	1,278,868	59,929	1,839
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(31,479)	805,941	231,682	7,109
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	(4,901)	48,887	(5,633)	138
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	763,545	727,165	1,581,993	48,231
CASH AND CASH EQUIVALENTS, END OF YEAR	<u>727,165</u>	<u>1,581,993</u>	<u>1,808,042</u>	<u>55,478</u>
<b>SUPPLEMENTAL INFORMATION</b>				
Exercise of stock option in lieu of offsetting accrued bonuses	—	—	28,602	878
Interest paid	169	46	33	1
Income taxes paid	450	38,175	113,362	3,478

The accompanying notes are an integral part of the consolidated financial statements.

(Concluded)

**SILICON MOTION TECHNOLOGY CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In Thousands)**

**1. ORGANIZATION AND OPERATIONS**

Silicon Motion Technology Corporation (“SMTC”, collectively with its subsidiaries the “Company”) is a holding company incorporated in the Cayman Islands on January 27, 2005. Substantially all of the Company’s operations are conducted through Silicon Motion, Inc. (“SMI”), a wholly-owned subsidiary of SMTC, located in Taiwan. The Company is a fabless semiconductor company that designs, develops and markets universally compatible, high-performance, low-power semiconductor solutions for the multimedia consumer electronics market. The Company’s semiconductor solutions include controllers used in mobile storage media, such as flash memory cards and USB flash drives and multimedia systems-on-a-chip, or SoCs, used in digital media devices such as MP3 players, embedded graphics applications and PC cameras.

SMI was incorporated in Taiwan on April 8, 1997 and its shares were approved for public issuance in Taiwan in December 1999. SMI’s common stock was traded on the Emerging Stock Market of the Taiwan GreTai Securities Market from June 27, 2003 to April 18, 2005 when SMI, following shareholder approval, terminated the quotation of its common shares. On April 25, 2005, shareholders of SMI exchanged an aggregate of 105,412 thousand shares of common stock of SMI for an aggregate of 105,412 thousand ordinary shares of SMTC. Therefore, all the shareholders of SMI became the holders of an aggregate of 100% of the outstanding shares of SMTC which in turn became the holder of 100% of the outstanding shares of SMI. SMI shareholders also approved to revoke SMI’s public company status in Taiwan. Such revocation was approved by the Securities and Futures Bureau of Taiwan on April 26, 2005.

As a result of the share exchange, 100% of the outstanding shares of SMTC are owned by former shareholders of SMI. Consequently, the exchange was accounted for as a reverse merger and the consolidated financial statements of SMTC present the historical results, assets and liabilities of SMI on the consummation of the reverse merger as if SMI was the acquirer.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Presentation**

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP). The consolidated financial statements include the accounts of SMTC and its wholly-owned subsidiaries. The Company owns 100% of the outstanding shares in all of its subsidiaries, except for Silicon Motion Hong Kong Limited which the Company owns 99.99%. All significant intercompany balances and transactions have been eliminated upon consolidation.

**Use of Estimates**

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect certain reported amounts and disclosures. The actual results could differ from those estimates.

**Concentration of Credit Risk**

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents, investment in debt securities and accounts receivable. Cash are deposited with high credit-quality financial institutions. For accounts receivable, the Company performs ongoing credit evaluations of its customers’ financial condition and the Company maintains an allowance for doubtful accounts receivable based upon a review of the expected collectibility of individual accounts.



## [Table of Contents](#)

The Company's direct and indirect customers include manufactures, OEMs and ODMs of major flash memory-based storage products as well as portable digital media devices. Many of the Company's customers sell brand name consumer electronics products that include the Company's products. For flash memory card, UFD and card reader controllers, the Company's worldwide customers include companies such as Lexar Media, Samsung, Sony, STMicroelectronics and Transcend. For the multimedia products, the Company's worldwide customers include Advantech, Fuji Xerox, GE, Intel, Kontron, Mattel, Panasonic, Philips, Sharp, Siemens, Sony, Thomson and Toshiba. For the year ended December 31, 2006, only one of the Company's customers individually accounted for greater than 10% of net sales. The Company's top ten customers in 2006 accounted for approximately 53% of net sales.

### **Fair Value of Financial Instruments**

The carrying amount of the Company's financial instruments, including cash and cash equivalents, notes and accounts receivable and notes and accounts payables approximates fair value due to the short-term maturity of the instruments. Fair values of short-term investments and long-term investments represent quoted market prices, if available. If no quoted market prices are available, fair values are estimated based on discounted cash flow, or other valuation techniques.

### **Cash Equivalents**

The Company considers all highly liquid investments with maturities within three months from the date of purchase to be cash equivalents.

### **Short-term Investments**

The Company invests its excess cash in bond funds and uses the average cost method for trading securities and available-for-sale securities when determining their cost basis. In 2005, the Company classified all of its short-term investments as available-for-sale securities, which are initially recognized at fair value with subsequent changes in fair value reported as unrealized gain or loss in a separate component of shareholders' equity. The Company sold all of its available-for-sale securities on December 31, 2005. In 2006, the Company changed its investment objective and classified all short-term investments purchased subsequent to December 31, 2005 as trading securities. Trading securities are initially recognized at fair value, with subsequent changes in fair value recorded in earnings as unrealized gains and losses.

### **Allowance for Doubtful Receivables**

An allowance for doubtful receivables is provided based on a review of the collectibility of accounts receivables. The Company determines the amount of allowance for doubtful receivables by examining the historical collection experience and current trends in the credit quality of its customers as well as its internal credit policies.

### **Inventories**

Inventories are stated at the lower of cost or market value. Inventories are recorded at standard cost and adjusted to the approximate weighted-average cost at the balance sheet date. Market value represents the current replacement cost for raw materials and net realizable value for finished goods and work in process. The Company assesses its inventory for estimated obsolescence or unmarketable inventory based upon management's assumptions about future demand and market conditions. In estimating reserves for obsolescence, the Company primarily evaluates estimates based on the timing of the introduction of new products and the quantities remaining of old products and provides reserves for inventory on hand in excess of the estimated demand. Estimated losses on slow-moving items are recognized and included in the allowance for losses.

### **Long-term Investments**

Long-term investments wherein the Company does not exercise significant influence are accounted for under the cost method of accounting. Management evaluates related information in addition to quoted market prices, if any, in determining the fair value of these investments and whether an other than temporary decline in value exists. Factors indicative of an other than temporary decline include recurring operating losses, credit defaults and subsequent rounds of financings at an amount below the cost basis of the investment. Management periodically weighs all quantitative and qualitative factors in determining if any impairment loss exists.

### **Property and Equipment**

Property and equipment are stated at cost less accumulated depreciation. Significant additions, renewals and betterments are capitalized, while maintenance and repairs are expensed as incurred.

Depreciation is computed using the straight-line method over estimated useful lives that range as follows: buildings — 25 years; machinery and equipment — 3 to 6 years; furniture and fixtures — 3 to 8 years; software — 1 to 5 years; leasehold improvement — the shorter of the estimated useful life or lease term, which is generally 2 to 6 years. Depreciation expense recognized for the years ended December 31, 2004, 2005 and 2006 was approximately NT\$21,734 thousand, NT\$23,906 thousand and NT\$ 35,596 thousand (US\$ 1,092 thousand), respectively.

Upon the sale or other disposal of property and equipment, the related cost and accumulated depreciation are removed from the accounts, and any gain or loss is credited or charged to current income.

### **Impairment of Long-Lived Assets**

The Company evaluates the recoverability of long-lived assets whenever events or changes in circumstances indicate the carrying value may not be recoverable. The determination of recoverability is based on an estimate of undiscounted cash flows expected to result from the use of an asset and its eventual disposition. The estimate of cash flows is based upon, among other things, certain assumptions about expected future operating performance, growth rates and other factors. Estimates of undiscounted cash flows may differ from actual cash flows due to, among other things, technological changes, economic conditions, changes to the business model or changes in operating performance. If the sum of the undiscounted cash flows is less than the carrying value, an impairment loss is recognized, measured as the amount by which the carrying value exceeds the fair value of the asset.

### **Other Assets**

Other assets consist of refundable deposits for obtaining foundry capacity, and office leases.

### **Other Restricted Assets**

Other restricted assets consist of deposits required for litigation in the Taiwan courts (Note 16).

### **Pension Costs**

For employees under defined contribution pension plans, pension costs are recorded based on the actual contributions made to employees' individual pension accounts. For employees under defined benefit pension plans, pension costs are recorded based on actuarial calculations.

### **Revenue Recognition**

Revenue from product sales is generally recognized upon shipment to the customer provided that the Company has received a signed purchase order, the price is fixed or determinable, transfer of title has

occurred in accordance with the shipping terms specified in the arrangement with the customer, collectibility from the customer is considered reasonably assured, product returns are reasonably estimable and there are no remaining significant obligations or customer acceptance requirements.

The Company grants certain distributors limited rights of return and price protection rights on unsold products. The return rights are generally limited to five percent of the monetary value of products purchased within the preceding six months, provided that the distributor places a corresponding restocking order of equal or greater value. An allowance for sales returns for distributors and all customers is recorded at the time of sale based on historical returns information available, management's judgment and any known factors at the time the financial statements are prepared that would significantly affect the allowance. Price protection rights are based on the inventory products the distributors have on hand at the date the price protection is offered. A reserve for price adjustments is recorded based on the estimated products on hand at the distributors and historical experience. The Company incurred actual price adjustments to distributors of NT\$838 thousand, NT\$4 thousand and NT\$512 thousand (US\$16 thousand) during 2004, 2005 and 2006, respectively.

The Company provides a warranty period of one year for manufacturing defects of its products. Warranty returns have been infrequent and relate to defective or off-specification parts. The Company estimates a reserve for warranty based on historical experience and records this amount to cost of sales. For the years ended December 31, 2004, 2005 and 2006, the Company did not experience significant costs associated with warranty returns.

### **Research and Development**

Research and development costs consist of expenditures incurred during the course of planned research and investigation aimed at the discovery of new knowledge that will be useful in developing new products or at significantly enhancing existing products as well as expenditures incurred for the design and testing of product alternatives. All expenditures related to research and development activities of the Company are charged to operating expenses when incurred. Third-party research and development costs are expensed when the contracted work has been performed or as milestone results have been achieved.

### **Advertising Expenses**

The Company expenses all advertising and promotional costs as incurred. Advertising costs charged to expense amounted to NT\$2,552 thousand, NT\$978 thousand and NT\$1,270 thousand (US\$39 thousand) for the years ended December 31, 2004, 2005, and 2006, respectively.

### **Income Taxes**

Income taxes are accounted for in accordance with Statement of Financial Accounting Standards ("SFAS") No. 109 "Accounting for Income Taxes". The provision for income tax represents income tax paid and payable for the current year plus the changes in the deferred income tax assets and liabilities during the years. Deferred income tax assets are recognized for net operating loss carryforwards, research and development credits, and temporary differences. The Company believes that uncertainty exists regarding the realizability of certain deferred income tax assets and, accordingly, has established a valuation allowance for those net deferred income tax assets to the extent the realizability is not deemed more likely than not.

Under Taiwan tax regulations, the current year's earnings, on an after tax basis, that are not distributed in the following year are subject to a 10% additional income tax. This 10% additional income tax is recognized in the period during which the related earnings are generated.

The R.O.C. government enacted the Alternative Minimum Tax Act (the AMT Act), which became effective on January 1, 2006. The alternative minimum tax (AMT) imposed under the AMT Act is a supplemental tax

## [Table of Contents](#)

levied at a rate of 10% which is payable if the income tax payable determined pursuant to the Income Tax Law is below the minimum amount prescribed under the AMT Act. The taxable income for calculating the AMT includes most of the income that is exempted from income tax under various laws and statutes. The Company has considered the impact of the AMT Act in the determination of its tax liabilities.

### **Foreign Currency Transactions**

Foreign currency transactions are recorded at the rates of exchange in effect when the transaction occurs. Gains or losses, resulting from the application of different foreign exchange rates when cash in foreign currency is converted into the entities' functional currency, or when foreign currency receivables and payables are settled, are credited or charged to income in the period of conversion or settlement. At the balance sheet date, assets and liabilities denominated in foreign currencies are remeasured based on prevailing exchange rates and any resulting gains or losses are credited or charged to income.

### **Translation of Foreign Currency Financial Statements**

The reporting currency of the Company is the New Taiwan dollar. The functional currency is the local currency of the respective entities. Accordingly, the financial statements of the foreign subsidiaries are translated into New Taiwan dollars at the following exchange rates: assets and liabilities — current rate on the balance sheet date; shareholders' equity — historical rates; income and expenses — average rate during the period. The resulting translation adjustment is recorded as a separate component of shareholders' equity in accumulated other comprehensive income.

### **Comprehensive Income (Loss)**

Comprehensive income and loss represents net income plus the results of certain changes in shareholders' equity during a period from non-owner sources that are not reflected in the consolidated statements of income.

### **Legal Contingencies**

The Company is currently involved in various claims and legal proceedings. Periodically, the Company reviews the status of each significant matter and assesses the potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be estimated, the Company accrues a liability for the estimated loss. Because of uncertainties related to these matters, accruals are based only on the best information available at the time. As additional information becomes available, the Company reassesses the potential liability related to the pending claims and litigation and revises these estimates as appropriate. Such revisions in the estimates of the potential liabilities could have a material impact on the results of operations and financial position.

### **Earnings Per Share**

Basic earnings per share are computed by dividing net earnings attributable to common/ordinary shareholders by the weighted average number of common/ordinary shares outstanding during the period. Diluted earnings per share reflect the potential dilution that could occur if potential common/ordinary stock was exercised. Common/ordinary stock equivalents are excluded from the computation of the diluted income per share in periods when their effect is anti-dilutive. The Company's common/ordinary stock equivalent consists only of common/ordinary stocks issuable upon the exercise of employee stock options (using the treasury stock method).

### **Stock-Based Compensation**

The Company grants stock options to its employees and directors. Prior to January 1, 2006, the Company accounted for options granted under Accounting Principles Board Opinion ("APB") No. 25, "Accounting for

## [Table of Contents](#)

Stock Issued to Employees” and complied with the disclosure requirements of SFAS No. 123, “Accounting for Stock-Based Compensation”. Under APB No. 25, compensation expense is measured based on the difference, if any, on the date of the grant, between the fair value of the Company’s stock and the exercise price.

On January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), “Share-Based Payment,” using the modified prospective application method. In accordance with the transition method, the Company’s consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS No. 123(R). The adoption of SFAS No. 123(R) resulted in incremental stock-based compensation expense of NT\$157,475 thousand (US\$4,832 thousand). The incremental stock-based compensation expense caused net income to decrease by NT\$85,699 thousand (US\$2,630 thousand) for the year ended December 31, 2006, and basic and diluted earnings per share to decrease by NT\$0.69 and NT\$0.60, respectively.

The following pro forma information, as required by SFAS No. 148, “Accounting for Stock-Based Compensation — Transition and Disclosure, an amendment of FASB Statement No. 123,” is presented for comparative purposes and illustrates the pro forma effect on net income and related earnings per share for the year ended December 31, 2005, as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation for that period.

	<u>Year ended</u> <u>December 31, 2005</u> NT\$ (In Thousands, except earnings per share)
Net income as reported	673,302
Add: Stock compensation as reported	—
Less: Stock compensation determined using the fair value method	<u>(52,181)</u>
Pro forma net income	<u>621,121</u>
Earnings per share:	
Basic as reported	<u>5.90</u>
Pro forma basic	<u>5.44</u>
Diluted as reported	<u>5.80</u>
Pro forma diluted	<u>5.35</u>

### **Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, “Fair Value Measurements”, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 does not require any new fair value measurements, but brings up guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. This statement is effective for the Company beginning January 1, 2008. The Company is currently assessing the potential impact that the adoption of SFAS No. 157 will have on the results of operations and financial position of the Company, and is not yet in a position to determine such effects.

In September 2006, the FASB issued SFAS No. 158, “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans — An Amendment of FASB Statements No. 87, 88, 106, and 132R” (SFAS No. 158). Provisions with respect to the recognition of an asset and liability related to the funded status and the changes in the funded status be reflected in comprehensive income are effective for fiscal years ending after December 15, 2006 and the change in measurement date provisions is effective for fiscal years ending after December 15, 2008. SFAS No. 158 also requires the measurement date of the plan’s funded status be the same as the Company’s fiscal year-end. The Company adopted all requirements of SFAS No. 158 for the year ended December 31, 2006. Upon the adoption of SFAS No. 158, the Company recognized an increase to accumulated other comprehensive income of NT\$2,100 thousand as of December 31, 2006.

## [Table of Contents](#)

In July 2006, the FASB issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109” (“FIN No. 48”). FIN No. 48 clarifies the accounting for uncertainty in income taxes by prescribing the recognition threshold a tax position is required to meet before being recognized in the financial statements. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006 and is required to be adopted by the Company in fiscal 2007. The cumulative effects, if any, of applying FIN No. 48 will be recorded as an adjustment to retained earnings as of the beginning of the period of adoption. The Company is currently evaluating the effect that the adoption of FIN No. 48 will have on the results of operations and financial position of the Company and is not yet in a position to determine such effects.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin (“SAB”) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Current Year Misstatements. SAB No. 108 requires analysis of misstatements using both an income statement (rollover) approach and a balance sheet (iron curtain) approach in assessing materiality and provides for a one-time cumulative effect transition adjustment. SAB No. 108 is effective for the Company’s fiscal year 2006 annual financial statements. There was no impact on the results of operations and financial position of the Company after adopting SAB No. 108.

In February 15, 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (SFAS No. 159). Under this standard, the Company may choose to report financial instruments and certain other items at fair value on a contract-by-contract basis with changes in value reported in earnings. This selection is irrevocable. SFAS No. 159 provides an opportunity to mitigate volatility in reported earnings that is caused by measuring hedged assets and liabilities that were previously required to use a different accounting method than the related hedging contracts when the complex provisions of SFAS No. 133 hedge accounting are not met. The Company believes that there is no impact on the result of operations and financial position of the Company after adoption of SFAS No. 159.

### **Reclassifications**

Certain accounts in the consolidated financial statements as of December 31, 2005 and for the years ended December 31, 2004 and 2005 have been reclassified to conform to the consolidated financial statements as of and for the year ended December 31, 2006. The Company reclassified compensation to customers from non-operating expense in 2005 to operating expense in 2006. The Company also reclassified and presented as separate items on the consolidated balance sheet for deferred income tax assets, net and other restricted assets, which were included in other assets in 2005.

### **3. US DOLLAR AMOUNTS**

The Company maintains its accounts and expresses its financial statements in New Taiwan dollars. For convenience only, U.S. dollar amounts presented in the accompanying financial statements have been translated from New Taiwan dollars, using the U.S. Federal Reserve Bank of New York non-buying rate of NT\$32.59 to US\$1 on December 29, 2006. The convenience translations should not be construed as representations that the New Taiwan dollar amounts have been, could have been or could in the future be, converted into U.S. dollars at this or any other exchange rate.

4. CASH AND CASH EQUIVALENTS

	December 31		
	2005 NT\$	2006 NT\$	US\$ (Note 3)
Cash and deposits in bank	1,258,092	1,269,400	38,951
Time deposits	300,906	434,700	13,338
Bonds acquired under repurchase agreements	22,995	103,942	3,189
	<u>1,581,993</u>	<u>1,808,042</u>	<u>55,478</u>

5. SHORT-TERM INVESTMENTS

Realized gains on sales of short-term investments were NT\$10,135 thousand, NT\$12,799 thousand and NT\$ 17,857 thousand (US\$ 548 thousand) for the years ended December 31, 2004, 2005 and 2006, respectively. Unrealized holding gains for available-for-sale securities were NT\$697 thousand and nil as of December 31, 2004 and 2005, respectively. Unrealized holding gains for trading securities was NT\$3 thousand (US\$0.1 thousand) as of December 31, 2006.

6. NOTES AND ACCOUNTS RECEIVABLE

	December 31		
	2005 NT\$	2006 NT\$	US\$ (Note 3)
Notes receivable	154,781	176,376	5,412
Trade accounts receivable	597,575	890,265	27,317
	752,356	1,066,641	32,729
Allowance for doubtful accounts	(5,973)	(13,433)	(412)
Allowance for sales returns and discounts	(18,104)	(35,067)	(1,076)
	<u>728,279</u>	<u>1,018,141</u>	<u>31,241</u>

The changes in the allowances are summarized as follows:

	Year Ended December 31			
	2004 NT\$	2005 NT\$	2006 NT\$	US\$ (Note 3)
Allowances for doubtful accounts				
Balance, beginning of year	1,918	4,833	5,973	183
Additions charged to expense	3,423	1,140	7,863	241
Write-offs	(508)	—	(403)	(12)
Balance, end of year	<u>4,833</u>	<u>5,973</u>	<u>13,433</u>	<u>412</u>

	Year Ended December 31			
	2004 NT\$	2005 NT\$	2006 NT\$	US\$ (Note 3)
Allowance for sales returns and discounts				
Balance, beginning of year	18,385	16,755	18,104	556
Additions	33,599	27,203	49,728	1,526
Write-offs	(35,229)	(25,854)	(32,765)	(1,006)
Balance, end of year	<u>16,755</u>	<u>18,104</u>	<u>35,067</u>	<u>1,076</u>

## [Table of Contents](#)

### 7. INVENTORIES

The components of inventories are as follows:

	December 31		
	2005	2006	
	NT\$	NT\$	US\$ (Note 3)
Finished goods	94,842	210,908	6,472
Work in process	116,080	162,831	4,996
Raw materials	67,606	53,377	1,638
	<u>278,528</u>	<u>427,116</u>	<u>13,106</u>

In December 2004, the Company recorded an inventory write-off of approximately NT\$49,362 thousand to cost of sales due to production defects associated with the migration from 0.35 micron to 0.18 micron manufacturing technologies for one of the Company's products, SM264. A portion of the defects stemmed from the Company's use of manufacturing process technology offered free of charge and developed by other companies. For these defective wafers, the Company sought indemnification from these companies and received NT\$4,968 thousand and NT\$19,121 thousand worth of replacement wafers in 2004 and 2005, respectively, for which the Company valued at the cost of the defective wafers, and such amounts were recorded as reductions in cost of sales for the years ended December 31, 2004 and 2005, respectively.

### 8. LONG-TERM INVESTMENTS

As of December 31, 2005 and 2006, the Company held equity investments in several private-held companies with the carrying values as follows:

	December 31		
	2005	2006	
	NT\$	NT\$	US\$ (Note 3)
Cost method:			
Cashido Corp. (Cashido) (2.40%)	3,142	3,142	96
Spright Co., Ltd. (Spright) (13.50%)	12,812	21,999	675
Chipmast Technology, Corp. (Chipmast) (18.92%)	—	55,909	1,716
Vastview Technology, Corp. (Vastview) (9.13%)	—	89,892	2,758
ARCHIC Technology, Corp. (Chipmast) (4.67%)	—	—	—
	<u>15,954</u>	<u>170,942</u>	<u>5,245</u>

In November 2005 and May 2006, the Company invested in Spright's common stocks. Spright is a multinational semiconductor assembly and testing company. Spright was formerly known as Flash Media Corporation.

In November and December 2006, the Company invested in the common stocks of Chipmast and Vastview, respectively. Chipmast is a semiconductor design and application company and Vastview is the electro — optical integrated company.

The Company accounts for these investments using the cost method as the Company does not have significant influence over the investees. These investments are evaluated for impairment on an annual basis or as the circumstances indicate. No impairment has been recorded for the years ended December 31, 2005 and 2006.

For the year ended December 31, 2004, due to the decline in value of the investment in ARCHIC which the Company determined to be other than temporary, the Company recorded a loss on impairment of such investments of NT\$4,053 thousand. As of December 31, 2005, ARCHIC was dissolved and NT\$1,159 thousand was returned to the Company upon liquidation.



**9. PROPERTIES AND EQUIPMENT**

	December 31		
	2005 NT\$	2006 NT\$	US\$ (Note 3)
Cost:			
Land	18,259	18,259	560
Buildings	13,907	13,907	427
Machinery and equipment	52,183	61,040	1,873
Furniture and fixtures	21,980	31,164	956
Leasehold improvement	14,821	19,206	589
Software	30,443	55,453	1,702
Total	<u>151,593</u>	<u>199,029</u>	<u>6,107</u>
Accumulated depreciation:			
Buildings	4,009	4,566	140
Machinery and equipment	19,053	30,958	950
Furniture and fixtures	10,794	14,749	451
Leasehold improvement	7,742	13,354	413
Software	26,261	38,252	1,172
	<u>67,859</u>	<u>101,879</u>	<u>3,126</u>
Prepayment and construction in progress	—	222,206	6,818
	<u>83,734</u>	<u>319,356</u>	<u>9,799</u>

The Company entered into capital leases for certain office equipment with remaining lease payments as of December 31, 2006 of NT\$281 thousand in 2007, NT\$203 thousand in 2008, and nil in 2009 and thereafter.

In April, 2006 the Company leased its identified land and buildings located in Taipei, Taiwan, to a third party under a three years operating lease. Net carrying value of the leased land and building as of December 31, 2006 was NT\$18,259 thousand (US\$560 thousand) and NT\$9,341 thousand (US\$287 thousand), respectively.

**10. INTANGIBLE ASSETS**

	December 31 2005 NT\$
Trademarks	11,834
Developed technology	56,735
	<u>68,569</u>
Accumulated amortization	(54,452)
Accumulated tax provision adjustments	(14,117)
	<u>—</u>

The Company records intangible assets in accordance with SFAS No. 141 “Business Combination” and SFAS No. 142, “Goodwill and Other Intangible Assets”. The above trademark and developed technology were acquired during the Company’s acquisition of SMI USA in August 2002.

The Company evaluates long-lived assets held and used by the Company for impairment whenever events or changes in circumstances indicate that their net book value may not be recoverable in accordance with

## [Table of Contents](#)

SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". During the fourth quarter of 2004, the Company determined that impairment of the intangible assets occurred as a result of a significant decline in revenue associated with the sales expected to be generated from the introduction of new consumer products such as the broadband internet video phone, car navigation system, and Tablet PC as next generation of notebook computers. As the market and the development for these products did not occur as anticipated, the forecasted revenues and cash flows were significantly impacted. The Company estimated the undiscounted cash flows taking into account the new information and determined that the carrying value of the developed technology was higher than the estimated cash flows. Accordingly, the Company reduced the carrying value of the developed technology to the fair value as determined by the estimated discounted cash flows. This resulted in an impairment charge of NT\$11,718 thousand that was recorded against intangibles and is included in the consolidated statements of income for the year ended December 31, 2004.

At December 31, 2005, SMI USA was able to recognize additional tax benefit associated with a valuation allowance that had been recorded at the purchase date for the related deferred tax assets. Accordingly, the Company reduced the value of the intangible assets by NT\$2,342 thousand to reflect the amount of the tax benefit.

### 11. ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

	December 31		
	2005	2006	US\$
	NT\$	NT\$	(Note 3)
Wages and bonus	112,173	156,788	4,811
Professional fees	12,117	18,854	579
Research and development payable	9,168	29,174	895
Commission payable	15,902	1,246	38
License fee payable	83	9,103	279
Accrued customer incentives	1,939	32,471	996
Others	56,250	46,380	1,424
	<u>207,632</u>	<u>294,016</u>	<u>9,022</u>

### 12. PENSION PLAN

The Labor Pension Act (the "Act") of Taiwan became effective on July 1, 2005 and the pension mechanism under the Act is deemed a defined contribution plan. The employees who were subject to the Labor Standards Law prior to July 1, 2005 were allowed to choose to be subject to the pension mechanism under the Act or continue to be subject to the pension mechanism under the Labor Standards Law. For those employees who were subject to the Labor Standards Law prior to July 1, 2005 and still work for the same company after July 1, 2005 and have chosen to be subject to the pension mechanism under the Act, their seniority as of July 1, 2005 shall be maintained. The Act prescribes that the rate of contribution by an employer to employees' pension accounts per month shall not be less than 6% of each employee's monthly salary. The Company made monthly contributions and recognized pension costs of NT\$3,476 thousand and NT\$ 8,831 thousand (US\$271 thousand) for the years ended December 31, 2005 and 2006, respectively.

The Company has defined benefit plans under the Labor Standards Law of Taiwan that provide benefits based on years of service and average salary computed based on the final six months of employment. The law requires companies incorporated in Taiwan to contribute between 2% to 15% of employee salaries to a government specified plan. SMI's plan makes monthly contributions equal to 2% of employee salaries to a government specified pension. Contributions are required to be deposited in SMI's pension name of the committee with the Central Trust of China in Taiwan. Future contributions will be based on 2% of the

## [Table of Contents](#)

employee salaries at that time. The Company estimates its contribution for the year ending December 31, 2007 to be NT\$1,800 thousand which was determined based on 2% of estimated salaries in 2007. The measurement date of the plan is December 31.

The effect of adopting SFAS No. 158 on individual line items in the consolidated balance sheet as of December 31, 2006 was as follows (in NT\$ thousand):

	Before Application of SFAS 158	Adjustments	After Application of SFAS 158
Liability for pension benefit	\$ 3,119	\$ (2,100)	\$ 1,019
Total liabilities	962,661	(2,100)	960,561
Accumulated other comprehensive income	43,674	2,100	45,774
Total shareholders' equity	4,566,023	2,100	4,568,123

The changes in benefits obligation and plan assets and the reconciliation of funded status are as follows:

	December 31		
	2005 NT\$	2006 NT\$	US\$ (Note 3)
<b>Change in benefit obligation</b>			
Projected benefit obligation at beginning of year	9,417	12,670	389
Service cost	2,334	46	1
Interest cost	365	412	13
Actuarial loss	554	1,569	48
Projected benefit obligation at end of year	<u>12,670</u>	<u>14,697</u>	<u>451</u>
<b>Change in plan assets</b>			
Fair value of plan assets at beginning of year	9,095	11,219	344
Actual return on plan assets	145	300	9
Employer contributions	1,979	2,159	66
Fair value of plan assets at end of year	<u>11,219</u>	<u>13,678</u>	<u>419</u>
<b>Reconciliation of funded status</b>			
Funded status	(1,451)	(1,019)	(32)
Unrecognized net transition obligation	26		
Unrecognized net actuarial gain	(3,940)		
<b>Net amount recognized</b>	<u>(5,365)</u>		

The net amount recognized is recorded both in the balance sheets as a long-term liability and accumulated other comprehensive income.

The accumulated benefit obligation for all the defined benefit pension plans was NT\$5,639 thousand in 2005.

[Table of Contents](#)

The components of net periodic benefit cost are as follows:

	Year Ended December 31			
	2004 NT\$	2005 NT\$	2006 NT\$	US\$ (Note 3)
Service cost	2,496	2,334	46	1
Interest cost	146	365	412	13
Projected return on plan assets	(294)	(342)	(397)	(12)
Amortization of unrecognized net transition obligation and unrecognized net actuarial gain	(362)	(175)	(148)	(5)
Curtailement loss	—	349	—	—
Net periodic benefit cost	<u>1,986</u>	<u>2,531</u>	<u>(87)</u>	<u>(3)</u>
	<u>2004</u>	<u>2005</u>	<u>2006</u>	
Weighted-average assumptions used to determine benefit obligations:				
Discount rate	3.50%	3.25%	2.75%	
Rate of compensation increase	5.00%	5.00%	5.00%	
Weighted-average assumptions used to determine net projected benefit cost:				
Discount rate	3.50%	3.25%	2.75%	
Expected long-term return on plan assets	3.50%	3.25%	2.75%	
Rate of compensation increase	5.00%	5.00%	5.00%	

**13. INCOME TAXES**

The components of income tax (benefit) expense are as follows:

	Year Ended December 31			
	2004 NT\$	2005 NT\$	2006 NT\$	US\$ (Note 3)
<b>Current</b>				
Domestic	—	—	—	—
Foreign				
SMI	78,186	64,398	100,343	3,086
SMI USA and others	450	389	6,393	196
	<u>78,636</u>	<u>64,787</u>	<u>106,736</u>	<u>3,282</u>
<b>Deferred</b>				
Domestic	—	—	—	—
Foreign				
SMI	52,703	(25,074)	(39,067)	(1,202)
SMI USA and others	1,762	2,342	(46,637)	(1,435)
	<u>54,465</u>	<u>(22,732)</u>	<u>(85,704)</u>	<u>(2,637)</u>
Income tax expense	<u>133,101</u>	<u>42,055</u>	<u>21,032</u>	<u>645</u>

[Table of Contents](#)

The income before income taxes for domestic and foreign entities is as follows:

	Year Ended December 31			
	2004	2005	2006	US\$
	NT\$	NT\$	NT\$	(Note 3)
Domestic	—	(44,415)	(121,391)	(3,725)
Foreign entities				
SMI	396,163	790,386	1,051,978	32,279
SMI USA	6,219	(16,056)	83,212	2,553
Others	(1,278)	(14,558)	(45,276)	(1,389)
	<u>401,104</u>	<u>715,357</u>	<u>968,523</u>	<u>29,718</u>

Since the Company is based in the Cayman Islands, a tax-free country, domestic tax on pretax income is calculated at the Cayman Islands statutory rate of zero for each year.

The Company and its subsidiaries file separate income tax returns. A reconciliation of income tax expense on pretax income at statutory rate and income tax expense is shown below:

	Year Ended December 31			
	2004	2005	2006	US\$
	NT\$	NT\$	NT\$	(Note 3)
Cayman statutory rate	—	—	—	—
Tax on pretax income at statutory rate	94,772	151,447	312,944	9,603
Tax-exempt income	—	(194,463)	(228,755)	(7,019)
Permanent differences	37,431	39,114	(35,090)	(1,077)
AMT	—	—	1,394	43
Income tax (10%) on undistributed earnings	51,170	81,173	75,721	2,323
Income tax credit utilized	(37,508)	(70,121)	(51,490)	(1,580)
Net change in net operating loss carryforwards	11,164	4,465	(1,882)	(58)
Net change in valuation allowance of deferred income tax assets	(29,067)	22,732	(112,737)	(3,460)
Effect of tax rate changes	—	3,889	4,938	152
Adjustment of prior years' taxes and others	5,139	3,819	55,989	1,718
Income tax expense	<u>133,101</u>	<u>42,055</u>	<u>21,032</u>	<u>645</u>

## [Table of Contents](#)

Deferred income tax assets were as follows:

	December 31		
	2005	2006	US\$
	NT\$	NT\$	(Note 3)
<b>Current:</b>			
Temporary differences and others	22,666	22,830	701
Investment tax credits	67,811	56,179	1,724
Net operating loss carryforwards	—	30,705	942
Valuation allowance	(41,619)	(6,111)	(188)
	<u>48,858</u>	<u>103,603</u>	<u>3,179</u>
<b>Non-current:</b>			
Temporary differences and others	7,217	(1,772)	(54)
Investment tax credits	63,479	86,457	2,653
Net operating loss carryforwards	308,065	247,806	7,604
Valuation allowance	(362,479)	(285,250)	(8,753)
	<u>16,282</u>	<u>47,241</u>	<u>1,450</u>

The valuation allowance shown in the table above relates to net operating loss carryforwards and tax credits for which the Company believes that realization is uncertain. As of December 31, 2006, the Company had unused research and development tax credits of NT\$89,000 thousand (US\$2,731 thousand) which will expire in 2010. In addition, profits generated from certain products are exempted from income tax for five years beginning January 1, 2005. For the years ended December 31, 2005 and 2006, the Company had NT\$777,851 thousand and NT\$915,018 thousand of tax-exempt income, resulting savings on income tax expense of NT\$194,463 thousand and NT\$228,755 thousand, respectively. Basic and diluted earnings per share effects from the savings on income tax expense were NT\$1.70 and NT\$1.67, and NT\$1.86 and NT\$1.82 for the years ended December 31, 2005 and 2006, respectively.

As of December 31, 2006, the Company's United States federal and state net operating loss carryforwards for income tax purposes were approximately NT\$754,133 thousand (US\$23,140 thousand) and NT\$384,398 thousand (US\$11,795 thousand), respectively. If not utilized, the federal net operating loss carryforwards will expire in 2021 and the state net operating loss carryforwards will expire in 2012.

As of December 31, 2006, the Company's United States federal and state research and development tax credit carryforwards for income tax purposes were approximately NT\$57,945 thousand (US\$1,778 thousand) and NT\$51,655 thousand (US\$1,585 thousand), respectively. If not utilized, the federal tax credit carryforwards will expire in 2021 while the state tax credit carryforward has no expiration date.

Current United States federal and California state laws include substantial restrictions on the utilization of net operating losses and credits in the event of an "ownership change" of a corporation. Accordingly, the Company's ability to utilize net operating loss and tax credit carryforwards may be limited as a result of such "ownership change". Such a limitation could result in the expiration of carryforwards before they are utilized.

SMI income tax returns through 2004 had been examined and cleared by the Taiwan tax authorities.

## 14. SHAREHOLDERS' EQUITY

### Appropriations from Earnings

Pursuant to the laws and regulations of the ROC and the respective Articles of Incorporation, the Company's subsidiary in Taiwan must make appropriations from annual earnings to non-distributable

reserve which could affect the Company's ability to pay cash or stock dividends, if any. The Taiwan subsidiary may only distribute dividends after it has made allowances as determined under ROC GAAP at each year-end for:

- a. Payment of taxes;
- b. Recovery of prior years' deficits, if any;
- c. 10% of remaining balance after deduction for a and b as legal reserve;
- d. Special reserve based on relevant laws or regulations or 10% of remaining balance for deduction from a to c as special reserve;
- e. Cash or stock bonus to employees at 0.01% of any remaining earnings after the above reserves have been appropriated based on a resolution of the board of directors. If bonus to employees is in the form of stock, the bonus may also be appropriated to employees of subsidiaries under the board of directors' approval;

In accordance with the above, SMI paid 15% of the remaining unappropriated earnings for 2004, in the form of 2,362 thousand shares of common stock, to employees as bonuses in the form of stock. The stock bonuses were recorded as compensation expense based on NT\$31.70 per share which was determined to be the fair value on the date of shareholder approval. In addition, SMI paid a stock dividend to its shareholders as part of their respective interests in the accumulated earnings of the Taiwan subsidiary. SMI recorded the dividend based on the fair value of the stock on the date of shareholder approval which was NT\$31.70 per share.

## 15. STOCK OPTION PLAN

### Stock Option Plan

In 2004, SMI adopted a 2004 Employee Stock Option Plan ("the 2004 Plan"). The 2004 Plan reserved 8,000 units with each unit entitled to subscribe for 1,000 shares of common stock after the requisite service is rendered. The options may be granted to qualified employees of the Company or any of its domestic or foreign subsidiaries and expire no later than six years from the date of grant. Generally, the options are granted at an exercise price not lower than the market value of the SMI's common stock at the date of the grant and vest over four years at certain percentages after two years from the date of grant. On December 31, 2004, 4,000 units were granted to employees at an exercise price of NT\$40 (US\$1.26) per share. As part of the share exchange between the Company and the shareholders of SMI effective on April 25, 2005, the Company agreed to assume the share options previously issued by SMI. Subsequently on June 3, 2005, the Company amended the 2004 Plan such that options under the 2004 Plan are granted at an exercise price not lower than the market value of the Company's ordinary shares at the date of the grant and vest over four years at certain percentages after one year from the date of grant.

On April 22, 2005, the Company adopted its 2005 Equity Incentive Plan ("the 2005 Plan"). The 2005 Plan provides for the grant of stock options, stock bonuses, restricted stock awards, restricted stock units and stock appreciation rights, which may be granted to employees (including officers), directors and consultants. The 2005 Plan reserved 10,000 thousand shares of ordinary shares, inclusive of the number of assumed share options under the 2004 Plan, for issuance upon the exercise of stock options.

In 2006, the Company amended the 2005 Plan to reserve additional 15,000 thousand shares of ordinary shares for issuance upon exercise of stock options.

### Adoption of SFAS No. 123(R)

The Company adopted SFAS No. 123(R) effective January 1, 2006. SFAS 123(R) requires the recognition of the fair value of stock compensation in net income. The Company recognizes stock compensation

## [Table of Contents](#)

expense over the requisite service period of the individual grantees, which generally equals the vesting period. Prior to January 1, 2006, the Company followed Accounting Principles Board Opinion 25, "Accounting for Stock Issued to Employees," and related interpretations in accounting for stock compensation. Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company's consolidated statements of income, because the exercise price of the Company's stock options granted to employees and directors equaled the fair value of the underlying stock at the date of grant.

The Company elected the modified prospective application method for adopting SFAS No. 123(R). Under this method, the unrecognized expense of awards not yet vested at January 1, 2006, the date of adoption is recognized in net income in the periods after the date of adoption using the same Black-Scholes valuation method and assumptions determined under the original provisions of SFAS No. 123, "Accounting for Stock-Based Compensation," as disclosed in the Company's previous annual report

Stock-based compensation expense recognized during the period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company's consolidated statement of income for the year ended December 31, 2006 includes compensation expense for stock options granted subsequent to December 31, 2005 and stock options granted before January 1, 2006 but unvested yet. The grant date fair values of those stock options were determined in accordance with the provision of SFAS No. 123 (R). The Company recognizes these compensation net of a forfeiture rate for only those awards expected to vest, on a straight line basis over the requisite service period of the award which is about 3- 4 years. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

### Stock Option Activity

Information about the Company's stock option activity and related information is as follows:

	Available For Grant (in Thousands)	Number of Options Shares (in Thousands)	Weighted Average Exercise Price (US\$)	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (US\$ thousand)
<b>Stock options under the 2004 and 2005 Plan</b>					
Outstanding at January 1, 2005	4,000	4,000	\$ 1.260		
Options authorized	2,000	—	—		
Options canceled	—	(4)	1.260		
Options granted	(4,350)	4,350	2.655		
Outstanding at January 1, 2006	1,650	8,346	1.987	7.43	\$ 8,453
Options authorized	15,000	—			
Options canceled	—	(513)	1.873		
Options granted	(2,950)	2,950	3.457		
Options exercised	—	(1,168)	1.790		\$ 14,415
Outstanding at December 31, 2006	13,700	9,615	2.468	7.49	\$ 13,690
Option Vested and expected to be vested after December 31, 2006		9,067	2.458	7.49	
Exercisable at December 31, 2006		1,152	2.288	7.49	\$ 1,934

The weighted-average-grant date fair value of stock options granted during the years ended December 31, 2004, 2005 and 2006 were US\$1.26, US\$2.66 and US\$3.46, respectively.



## [Table of Contents](#)

As of December 31, 2006, there was NT\$ 184,785 thousand (US\$5,670 thousand), net of estimated forfeitures, of total unrecognized compensation cost related to non-vested share-based compensation awards granted under the Company's stock option plans. This cost will be amortized over a weighted average period of approximately 2.27 years.

The aggregate intrinsic value in the table above represents the total intrinsic value (the difference between the Company's closing stock price on the last trading day of fiscal year 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2006. Intrinsic value will change in future periods based on the fair market value of the Company's stock and the number of shares outstanding.

### **Determining Fair Value**

The Company estimated the fair value of each option grant on the date of grant using the Black-Scholes option pricing model. The Black-Scholes option valuation model was developed for estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation model requires the input of highly subjective assumptions, including the expected stock price volatility. The Company used the following weighted-average assumptions for each year in calculating the fair value of the options granted:

	December 31		
	2004	2005	2006
Expected dividend yield	—	—	—
Expected volatility	71.24%	59.82%~66.39%	55.35%~68.17%
Risk free interest rate	3.50%	4.10%~4.37%	4.74%~5.03%
Expected life	1.63~4.63 years	2.38 years	3.08 years

The Company estimated the fair value of each option grant on the date of grant using the Black-Scholes option pricing model that use the assumptions in the following table. Risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. Expected volatilities are based on historical volatilities of stock prices of companies similar to the Company. Expected term represents the periods that the Company's share-based awards are expected to be outstanding and was determined based on historical experience regarding similar awards, giving consideration to the contractual term of the share-based awards. The dividend yield is zero as the Company has never declared or paid dividends on the ordinary shares or other securities and does not anticipate paying dividends in the foreseeable future.

## **16. COMMITMENTS AND CONTINGENCIES**

In 2001, SMI received a subsidy from the ROC Industrial Development Bureau (IDB) for research and development of controller products and a semiconductor data storage system. The subsidy was in the form of cash of NT\$5,093 thousand and non-interesting bearing loan of NT\$5,093 thousand. The non-interesting bearing loan in eight consecutive quarterly payments and has been totally paid off by the Company in January 2005. SMI is required to pay the IDB 2% of sales as royalty payments from any products resulting from the research and development project for a period of three years following the initial sale. Total royalties paid cannot exceed 30% of the total amount of the subsidy loan amount, or approximately NT\$1,530 thousand. As of December 31, 2006, the Company completed the research and development project under this agreement; however, the Company has not sold any products using this technology and therefore has not paid or accrued any royalty payments related to the projects.

As of December 31, 2006, the Company had a credit facility to NT\$70 million with China Trust Bank. This credit facility can be used for multi-purposes and is subject to annual renewal.

### **Operating Leases**

The Company entered into various operating lease agreements for office space that expire on various dates through May 2008. The Company recognized rent expense during the years ended December 31, 2004, 2005 and 2006 of NT\$18,702 thousand, NT\$24,215 thousand and NT\$33,673 thousand (US\$1,033 thousand), respectively. The minimum operating lease payments under these leases as of December 31, 2006 were NT\$17,304 thousand and NT\$3,377 thousand for the years ending December 31, 2007 and 2008, respectively.

### **Litigation**

On January 2, 2003, O2Micro International Limited, or O2Micro, a Cayman Islands company, filed an action for a preliminary injunction against SMI Taiwan with the Taiwan Hsinchu District Court. The request for such preliminary injunction alleged that SMI Taiwan produced and sold products with embedded digital sound effect control chips that infringed O2Micro's patent, patent registered number 130953, in Taiwan and asked for an order prohibiting SMI Taiwan from manufacturing and selling certain products that allegedly infringe O2Micro's patent in Taiwan. On February 6, 2003, SMI Taiwan filed an action for a preliminary injunction against O2Micro denying such allegations and requesting O2Micro not to interfere with SMI Taiwan's distribution, manufacturing and business operations in relation to the relevant products. A court-appointed appraiser completed a report on December 16, 2004 stating that SMI Taiwan's products raised in the case do not infringe O2Micro's patent. The appraiser's report was submitted to the court. O2Micro's application for a preliminary injunction was thus dismissed and O2Micro appealed this case to the Taiwan High Court on November 28, 2005.

On January 14, 2004, O2Micro filed for a preliminary injunction against SMI Taiwan and Microstar, a Taiwan customer of SMI Taiwan with the Taiwan Panchiao District Court. The request for injunctive relief asked for an order prohibiting SMI Taiwan and Microstar from designing, manufacturing, advertising and selling certain products that allegedly infringe O2Micro's patent, patent registered number 178290, in Taiwan. On May 20, 2004, the Taiwan Panchiao District Court issued a preliminary injunctive order prohibiting SMI Taiwan and Microstar from designing, manufacturing, advertising and selling certain products that allegedly infringe O2Micro's patent in Taiwan. SMI Taiwan appealed this case to the Taiwan High Court. The Taiwan High Court rejected the appeal on March 10, 2005, and SMI Taiwan appealed to the Taiwan Supreme Court. On November 10, 2005, the Taiwan Supreme Court vacated the Taiwan High Court Ruling and the case was remanded for further proceedings. The enforcement of such preliminary injunctive order has been withdrawn upon the deposit with the court by SMI Taiwan of NT\$11,506 thousand (US\$353 thousand).

On February 3, 2004, O2Micro filed an application for a provisional seizure of NT\$15 million against SMI Taiwan with the Taiwan Hsinchu District Court. The application alleged that SMI Taiwan infringed O2Micro's patent, patent registered number 130953, in Taiwan. The Taiwan Hsinchu District Court issued a provisional seizure order and attached some of SMI Taiwan's assets. Upon placing a deposit of NT\$15 million, the Taiwan Hsinchu District Court has released the enforcement of the provisional seizure order.

On September 24, 2004, O2Micro filed an action against SMI Taiwan with the Taiwan Hsinchu District Court. The complaint alleges that SMI Taiwan infringed O2Micro's patent, Taiwan patent registered number 130953, and O2Micro has requested SMI Taiwan to cease and desist the tortious act and a preliminary compensation in the amount of NT\$3 million (US\$92,000). On February 9, 2007, SMI Taiwan and O2Micro agreed to withdraw this case, as well as all the above-mentioned claims and application. As a result of this agreement, the management of SMI believes this case will not adversely affect SMI's operations or financial condition.

On May 1, 2005, SMI Taiwan incurred a loss on inventory in the possession of subcontractor, Advanced Semiconductor Engineering Inc. (hereinafter referred to ASE) due to fire, SMI Taiwan is currently in the claims process with ASE. for an amount exceeding the book value of loss inventory. After consultation with

## [Table of Contents](#)

the Company's outside legal counsel, the Company believes it is highly probable for the Company to receive reimbursement for the lost inventory at full book value, and the Company subsequently recorded NT\$41,226 thousand (US\$1.3 million) of inventory loss, offset by NT\$41,226 thousand (US\$1.3million) of fire loss reimbursement, resulting in zero impact to the earnings for the period. In connection with the inventory loss, the Company also recorded NT\$8,122 thousand (US\$249,000) under operating expenses for amounts paid to certain customers for delays in shipment caused by the fire.

On December 12, 2005, SMI Taiwan filed an action against ASE with the Taiwan Taoyuan District Court. SMI Taiwan alleges that ASE destroyed the wafer which SMI Taiwan had consigned to ASE with the OEM Agreement between SMI and ASE, and that ASE should pay SMI Taiwan a sum of NT\$77,218 thousand (US\$2.4 million) for damages. As of April 30, 2007, the Taiwan Taoyuan District Court is presently conducting the preparatory proceeding.

Our management currently believes that the legal proceedings described above, individually or in the aggregate, will not have a material adverse effect on our financial position or operating results. The litigation and other claims noted above, however, are subject to inherent uncertainties and management's view of these matters may change in the future.

## 17. SEGMENT INFORMATION

The Company designs, develops and markets semiconductor products. The Company operates in one segment. The chief operating decision maker, the Chief Executive Officer, reviews financial information presented on a consolidated basis for purposes of making operating decisions and assessing financial performance.

Net sales by product consist of the following (in thousands):

Product	Year Ended December 31			
	2004 NT\$	2005 NT\$	2006 NT\$	US\$ (Note 3)
Mobile storage products	1,865,699	2,270,121	3,004,507	92,192
Multimedia SoCs	285,441	402,139	432,072	13,257
Other	15,587	14,232	23,880	733
	<u>2,166,727</u>	<u>2,686,492</u>	<u>3,460,459</u>	<u>106,182</u>

## [Table of Contents](#)

Net sales by geographic area are presented based upon the customer's bill to location (in thousands):

Country	Year Ended December 31			
	2004 NT\$	2005 NT\$	2006 NT\$	US\$ (Note 3)
Taiwan	1,278,044	1,576,731	2,021,288	62,022
United States	675,943	515,848	340,327	10,443
Japan	97,431	98,510	116,272	3,568
Korea	19,754	119,198	368,198	11,298
China	58,679	249,842	307,422	9,433
Others	36,876	126,363	306,952	9,418
	<u>2,166,727</u>	<u>2,686,492</u>	<u>3,460,459</u>	<u>106,182</u>

Long-lived assets by geographic area were as follows (in thousands):

Country	December 31			
	2004 NT\$	2005 NT\$	2006 NT\$	US\$ (Note 3)
Taiwan	67,584	79,023	308,117	9,454
United States	4,565	3,377	2,891	89
Others	351	1,334	8,348	256
	<u>72,500</u>	<u>83,734</u>	<u>319,356</u>	<u>9,799</u>

In 2004, Power Digital, Lexar Media and Macrontron System accounted for 22%, 14% and 13% of net sales, respectively. In 2005, ATP accounted for 11% of net sales. In 2006, Silitrontech accounted for 12% of net sales.

## 18 SUBSEQUENT EVENTS

On April 30, 2007, the Company completed its acquisition of Future Communications IC, Inc., ("FCI") a leading designer of radio frequency integrated circuits (RF ICs) for mobile television and wireless communications based in Seoul, South Korea.

The acquisition was accounted for as a purchase transaction. The final purchase price for the transaction was approximately US\$50 million in cash and US\$40 million in the Company's ordinary shares and options to purchase the Company's ordinary shares. The Company has agreed to pay FCI shareholders up to an additional US\$12 million in cash under certain circumstances. The first condition is that FCI achieves, for its fiscal year 2007 ending December 31, 2007, a US\$33 million revenue target and a 53% product margin target. The second condition relates to the performance of the Company's stock. If both the FCI revenue and product margin targets are reached, the Company has agreed to pay to FCI shareholders in cash the difference between US\$12 million and 90% of the appreciation of the Company's ADSs over an agreed period of time in the stock portion of the consideration received as part of this transaction.

**GLOSSARY OF TECHNICAL TERMS**

AC-Link/IIS	An audio interface. Has significant advantages over the most prevalent power conversion technologies, which are based on Pulse Width Modulation (PWM). These advantages stem from the simplicity and versatility of its circuit topology (hardware), combined with the sophistication of its control methodology (software).
ACS	Adjacent Channel Selectivity. ACS is a measurement of a receiver's ability to process a desired signal while rejecting a strong signal in an adjacent frequency channel. ACS is defined as the ratio of the receiver filter attenuation on the assigned channel frequency to the receiver filter attenuation on the adjacent channel frequency.
AsH <sub>3</sub>	Arsine. A colorless, flammable, highly toxic gas used as a doping agent for the preparation of semiconductor materials.
Bad block	Most NAND flash, like all types of mass storage memory, contain some initial bad blocks within the memory array, which are typically marked as bad by the manufacturer to indicate that they should not be used. Because good blocks in a NAND flash can degrade and wear out, it is important for devices using NAND flash to track not only the initial, factory-marked bad blocks but also the blocks that go bad during normal operation and manage this issue with appropriate bad block management algorithm. A block is the smallest erasable entity in a NAND flash.
Bit error	A NAND flash is occasionally affected by corruption of memory at the binary digit (bit) level, which must be corrected by complex error correcting algorithms, know as error correction codes (ECC).
Board estate	The space a device occupies on a motherboard.
CF	Compact Flash. A type of non-volatile memory storage media commonly used in portable devices such as personal computers, digital cameras, video camcorders, and audio players.
CDMA	Code division multiple access. A form of multiplexing and a method of multiple access that divides up a radio channel by using different pseudo-random code sequences for each user. Also refers to digital cellular telephony systems that make use of this multiple access scheme.
CMOS	Complementary Metal Oxide Silicon. A fabrication process that incorporates n-channel and p-channel complementary metal oxide semiconductor transistors within the same silicon substrate. This is the most commonly used integrated circuit fabrication process technology.
CPU	Central Processing Unit.
DAB	Digital Audio Broadcasting. A technology for broadcasting audio using digital radio transmission.

## [Table of Contents](#)

DRAM	Dynamic Random Access Memory. A memory cell in which digital information (data) is stored in a volatile state. It is a key component of digital circuits.
DSC	Digital Still Camera
DVB-H	Digital Video Broadcasting — Handheld. A technical specification for bringing digit TV broadcast services to mobile phones. The major competitor of this technology is Digital Multimedia Broadcasting (DMB), which can either operate via terrestrial ( <i>see</i> T-DMB) or satellite ( <i>see</i> S-DMB) transmission.
DualMon	Our technology that enables one graphics processor to control two different displays containing two different images, which saves cost and board estate.
DVD	Digital video disc
IC	Integrated Circuit. A miniaturized electronic circuit (consisting mainly of semiconductor devices, as well as passive components) that has been manufactured in the surface of a thin substrate of semiconductor material.
Interleaving	A method of writing to multiple NAND flash memories simultaneously to increase the data transfer rate between the storage device and the host device.
JPEG	Joint Photographic Experts Group. A commonly used standard method of compression for digital images.
FastMDC	Fast Management Data-link & Calculation. A cost-effective solution for ultra high performance of flash access time and high reliability of data storage.
Flash memory	A type of solid-state, non-volatile memory. The name “flash” is derived from the rapid block erase operation. Flash memory is the most popular form of non-volatile semiconductor memory currently available.
LCD	Liquid Crystal Display.
LNA	Low Noise Amplifier. A semiconductor device in the receiver section of a wireless system that receives signals from an antenna at extremely low signal levels which are amplified by a factor of approximately 10 to 1,000 with the addition of as little interference as possible.
Memory	A device that can store information for later retrieval.
Memory Stick	A removable flash memory card format developed by Sony. Also used in general to describe the whole family of Memory Sticks, including the Memory Stick PRO, a revision that allows greater storage capacity and faster file transfer speeds (including the Memory

## Table of Contents

Stick PRO-HG, a high speed variant of the PRO, to be used for high definition still and video cameras); Memory Stick Duo, a small-form-factor version of the Memory Stick (including the PRO Duo); and the even smaller Memory Stick Micro (M2).

Micron	A term for micrometer, which is a unit of linear measure that equals one one-millionth (1/1,000,000) of a meter. There are 25.4 microns in one one-thousandth of an inch.
Mixed-signal	The combination of analog and digital circuitry in a single semiconductor.
MLC	Multi-Level Cell. A NAND flash technology that enables two or more times the capacity compared to a SLC NAND flash, therefore more capacity for a similar cost. A 2x MLC stores 2 bits of data per physical cell instead of the traditional 1 bit per cell using SLC technology.
MMC	MultiMediaCards. A flash memory card format. Also used in general to describe the whole family of MMCs, including RS-MMC, a smaller form-factor version of MMC, and the even smaller MMCmicro.
MMCA	MultiMediaCard Association. A memory card organization that promotes the MMC format.
MP3	MPEG-1 Audio Layer 3. A popular audio encoding format, which uses compression algorithm that is designed to greatly compress the amount of data required to represent the audio recording.
NAND flash	A type of flash memory.
ODM	Original Design Manufacturer.
OEM	Original Equipment Manufacturer.
PA	Power Amplifier. Provides signal amplification in the transmitter section of a wireless system in order to boost a signal through the antenna.
PC Architecture	The design of a personal computer (i.e. configuration of the motherboard, CPU and memory).
PCMCIA	Personal Computer Memory Card International Association. An organization consisting of some 500 companies that has developed a standard for PC cards used in notebook computers.
PDA	Personal Digital Assistant.
PH <sub>3</sub>	Phosphine. Gaseous compound commonly used in silicon manufacturing as a source of phosphorus.
RAM	Random Access Memory. A type of data storage used in computers that allows the stored data to be accessed at random.

## [Table of Contents](#)

ReadyBoost	A data caching technology first included with Microsoft's Windows Vista operating system. It aims to make computers running Windows Vista more responsive by using flash memory on a USB 2.0 drive, SD card, CompactFlash, or other form of flash memory, in order to boost system performance.
ReduceOn	Our graphics processor technology which enables intelligent power management that algorithmically varies the clock and power to functional units based on system needs to significantly reduce average operating power usage.
RF IC	Radio Frequency Integrated Circuit. Includes amplifiers, mixers, modulators/demodulators, receivers, transmitters and transceivers.
S-DMB	Satellite Digital Multimedia Broadcasting. A satellite digital radio transmission system for sending multimedia (radio, TV, and datacasting) to mobile devices such as mobile phones.
SD	Secure Digital. A flash memory card format. Also used in general to describe the whole family of SD cards, including miniSD, a smaller form-factor version of SD, and the even smaller microSD.
SDCA	Secure Digital Card Association. A memory card organization that promotes the SD format.
SDRAM	Synchronous DRAM. A type of DRAM ( <i>see</i> DRAM) that can run at much higher clock speeds than conventional memory. SDRAM synchronizes itself with the CPU's bus.
Semiconductor	An element with an electrical resistivity within the range of an insulator and a conductor. A semiconductor can conduct or block the flow of electric current depending on the direction and magnitude of applied electrical biases. Refers to the controller, multimedia SoC, RF IC, etc.
Semiconductor solution	Includes the controller as well as the software.
SiP	System-in-Package. A multi-chip module that integrates a number of integrated circuits enclosed in a single package. A SiP solution is valuable in space constrained environments such as MP3 players and mobile phones and helps reduce the complexity of the PCB and overall design.
SLC NAND	Single-Level Cell. A 1 bit of data per physical cell NAND flash memory technology. SLC offers less capacity per cost compared to MLC, but better robustness, reliability, speed and endurance
SoC	System-on-a-Chip. A chip that incorporates functions usually performed by several different devices into a single chip and therefore generally offers better performance and lower cost.
SPI	Serial Peripheral Interface. A board-level serial peripheral bus.



## [Table of Contents](#)

STiMi	Satellite Terrestrial Interactive Multiservice Infrastructure. A mobile TV broadcasting standard developed by the Academy of Broadcasting Science of China's State Administration of Radio Film and Television (SARFT).
T-DMB	Terrestrial Digital Multimedia Broadcasting. A terrestrial digital radio transmission system for sending multimedia (radio, TV, and datacasting) to mobile devices such as mobile phones.
Two plane architecture	A NAND flash architecture that allows simultaneous transfer of data in and out of two different memory planes, nearly doubling memory performance.
UFD	USB Flash Drive.
USB	Universal Serial Bus.
WCDMA	Wideband Code Division Multiple Access. A type of 3G cellular network that utilizes the direct sequence CDMA signaling method to achieve higher speeds and support more users.
Wear-leveling	A technique for prolonging the service life of certain kinds of erasable computer storage media, such as flash memory and hard disk drives by arranging data so that erasures and re-writes are distributed evenly across the medium. In this way, no single part of the medium prematurely fails due to a high concentration of write cycles.
Windows Media DRM	A Digital Rights Management service for the Windows Media platform, which is designed to provide secure delivery of audio and/or video content over an IP network to a PC or other playback device in such a way that the distributor can control how that content is used.
WMA	Windows Media Audio. Microsoft's proprietary audio codec designed to compete with MP3.
xD	xD Picture Card. A flash memory card format.

AMENDED AND RESTATED  
SILICON MOTION TECHNOLOGY CORPORATION

2005 EQUITY INCENTIVE PLAN

1. **PURPOSES.**

**(a) General Purpose.** The Company, by means of the Plan, seeks to retain the services of Eligible Recipients, to secure and retain the services of new members of this group and to provide incentives for such persons to exert maximum efforts for the success of the Company and, if applicable, any of the Company's parents and subsidiaries.

**(b) Available Stock Awards.** The purpose of the Plan is to provide a means by which Eligible Recipients may be given an opportunity to benefit from increases in value of the Ordinary Shares through the granting of the following Stock Awards: (i) Incentive Stock Options, (ii) Nonstatutory Stock Options, (iii) stock bonuses, (iv) Restricted Stock grants, (v) Restricted Stock Unit grants and (vi) Stock Appreciation Rights.

2. **DEFINITIONS.**

**"Affiliate"** means any Parent or Subsidiary of the Company, whether now or hereafter existing.

**"Board"** means the Board of Directors of the Company.

**"Change in Control"** means (i) the consummation of a merger or consolidation of the Company with or into another entity or any other corporate reorganization, if more than 50% of the combined voting power of the continuing or surviving entity's securities outstanding immediately after such merger, consolidation or other reorganization is owned by persons who were not shareholders of the Company immediately prior to such merger, consolidation or other reorganization; or (ii) the sale, transfer or other disposition of all or substantially all of the Company's assets. A transaction shall not constitute a Change in Control if its sole purpose is to change the jurisdiction of the Company's incorporation or to create a holding company that will be owned in substantially the same proportions by the persons who held the Company's securities immediately before such transaction.

**"Code"** means the Internal Revenue Code of 1986, as amended.

**"Committee"** means a committee of one or more members of the Board appointed by the Board in accordance with Section 3(c) of the Plan.

**"Company"** means Silicon Motion Technology Corporation, a company organized under the laws of the Cayman Islands.

**"Consultant"** means any person, including an advisor, (i) engaged by the Company or an Affiliate to render consulting or advisory services and who is compensated for such services, including members of any advisory board constituted by the Company, or (ii) who is a member of the Board of Directors of an Affiliate. However, the term "Consultant" shall not include either Directors who are not compensated by the Company for their services as Directors or Directors who are merely paid a director's fee by the Company for their services as Directors.

**"Continuous Service"** means, with respect to Employees, service with the Company or an Affiliate that is not interrupted or terminated. With respect to Directors or Consultants, Continuous Service means service with the Company, or a Parent or Subsidiary of the Company, whether as a Director or Consultant, that is not interrupted or terminated. The Board or the chief executive officer of the Company, in that party's sole discretion, may determine whether Continuous Service shall be considered interrupted in the case of any leave of absence approved by that party, including sick leave, military leave or any other personal leave.

**“Director”** means a member of the Board of Directors of the Company.

**“Disability”** means the permanent and total disability of a person within the meaning of Section 22(e)(3) of the Code.

**“Eligible Recipient”** means any Employee, Director or Consultant of the Company or any Employee, Director or Consultant of a Parent or Subsidiary of the Company or any Eligible Trust.

**“Eligible Trust”** means any trust established for the benefit of all or substantially all of the Eligible Recipients for purposes of receiving, holding and exercising rights under Stock Awards to operate in conjunction with any subplan established pursuant to Section 5(d) of the Plan and designated by the Committee as appropriate for such purposes.

**“Employee”** means any person employed by the Company or an Affiliate. Mere service as a Director or payment of a director’s fee by the Company or an Affiliate shall not be sufficient to constitute “employment” by the Company or an Affiliate.

**“Exchange Act”** means the Securities Exchange Act of 1934, as amended.

**“Executive Officer”** means an executive officer within the meaning of NASD Rule 4350(c), or any successor rule, as in effect from time to time.

**“Fair Market Value”** means, as of any date, the value of the Ordinary Shares determined as follows:

(i) If the Ordinary Shares are listed on any established stock exchange or traded on the Nasdaq National Market or the Nasdaq SmallCap Market, the Fair Market Value of an Ordinary Share shall be the closing sale price for such stock (or the closing bid, if no sale was reported) as quoted on such exchange or market (or the exchange or market with the greatest volume of trading in the Ordinary Shares) on the day of determination, as reported in *The Wall Street Journal* or such other source as the Board deems reliable.

(ii) In the absence of such markets for the Ordinary Shares, the Fair Market Value shall be determined in good faith by the Board using a reasonable valuation method.

**“FAS 123”** shall mean Statement of Financial Accounting Standard 123, “Accounting for Stock-based Compensation,” as promulgated by the Financial Accounting Standards Board.

**“Former Plan”** shall mean the Silicon Motion, Inc. Guidelines for Issuance and Subscription of Employee Stock Options approved by Silicon Motion Inc.’s board of directors on June 30, 2004, as amended on December 20, 2004.

**“Former Plan Shares”** has the meaning set forth in Section 4(b) of the Plan.

**“Incentive Stock Option”** means an Option intended to qualify as an incentive stock option within the meaning of Section 422 of the Code and the regulations promulgated thereunder.

**“Independent Director”** means an independent director as defined in NASD Rule 4200(a)(15), or any successor rule, as in effect from time to time.

**“Non-Employee Director”** means a Director who either (i) is not a current Employee or Officer of the Company or its parent or a subsidiary, does not receive compensation (directly or indirectly) from the Company or its parent or a subsidiary for services rendered as a consultant or in any capacity other than as a Director or member of a Board committee, or (ii) is otherwise considered a “non-employee director” for purposes of Rule 16b-3 under the Exchange Act.

**“Nonstatutory Stock Option”** means an Option not intended to qualify as an Incentive Stock Option.

**“Officer”** means a person who is an officer of the Company within the meaning of Section 16 of the Exchange Act and the rules and regulations promulgated thereunder.

**“Option”** means a stock option granted pursuant to Section 6 of the Plan.

**“Option Agreement”** means a written agreement between the Company and an Optionholder evidencing the terms and conditions of an individual Option grant. Each Option Agreement shall be subject to the terms and conditions of the Plan.

**“Optionholder”** means a person to whom an Option is granted pursuant to the Plan or, if applicable, such other person who holds an outstanding Option.

**“Ordinary Shares”** means the ordinary shares of the Company.

**“Outside Director”** means a Director who either (i) is not a current employee of the Company or an “affiliated corporation” (within the meaning of Treasury Regulations promulgated under Section 162(m) of the Code), is not a former employee of the Company or an “affiliated corporation” receiving compensation for prior services (other than benefits under a tax qualified pension plan), was not an officer of the Company or an “affiliated corporation” at any time and is not currently receiving direct or indirect remuneration from the Company or an “affiliated corporation” for services in any capacity other than as a Director, or (ii) is otherwise considered an “outside director” for purposes of Section 162(m) of the Code.

**“Parent”** means a “parent corporation,” whether now or hereafter existing, as defined in Section 424(e) of the Code.

**“Participant”** means a person to whom a Stock Award is granted pursuant to the Plan or, if applicable, such other person who holds an outstanding Stock Award.

**“Performance Criteria”** shall have the meaning set forth in Section 7(b)(iii) of the Plan.

**“Plan”** means this 2005 Equity Incentive Plan, as amended from time to time.

**“Re-Load Option”** has the meaning set forth in Section 6(m) of the Plan.

**“Repurchase Blackout Period”** means six (6) months from the date the Ordinary Shares relating to a Stock Award is issued to the Participant or, in the case of a Stock Award with vesting restrictions, six (6) months from the vesting date or, in any case, such longer or shorter period of time as required to avoid a variable charge to earnings for financial accounting purposes.

**“Restricted Stock”** shall mean a grant of Ordinary Shares pursuant to Section 7(b) of the Plan.

**“Restricted Stock Units”** shall mean a grant of the right to receive Ordinary Shares in the future or their cash equivalent (or both) pursuant to Section 7(b) of the Plan.

**“Securities Act”** means the Securities Act of 1933, as amended.

**“Stand-Alone Stock Appreciation Right”** has the meaning set forth in Section 7(c) of the Plan.

**“Stock Appreciation Right”** means the right to receive appreciation in the Ordinary Shares pursuant to the provisions of Section 7(c) of the Plan.

**“Stock Award”** means any right granted under the Plan, including an Option, a stock bonus, a Stock Appreciation Right, a Restricted Stock grant and a Restricted Stock Unit grant.

**“Stock Award Agreement”** means a written agreement between the Company and a holder of a Stock Award evidencing the terms and conditions of an individual Stock Award grant. Each Stock Award Agreement shall be subject to the terms and conditions of the Plan.

**“Subsidiary”** means (1) in the case of an Incentive Stock Option, a “subsidiary corporation,” whether now or hereafter existing, as defined in Section 424(f) of the Code, and (2) in the case of any other Stock Award, in addition to a subsidiary corporation as defined in clause (1), (A) a limited liability company, partnership or other entity in which the Company controls fifty percent (50%) or more of the voting power or equity interests, or (B) an entity with respect to which the Company possesses the power, directly or indirectly, to direct or cause the direction of the management and policies, whether through the Company’s ownership of voting securities, by contract or otherwise.

**“Tandem Stock Appreciation Right”** has the meaning set forth in Section 7(c) of the Plan.

**“Ten Percent Shareholder”** means a person who owns (or is deemed to own pursuant to Section 424(d) of the Code) stock comprising more than ten percent (10%) of the total combined voting power of all classes of stock of the Company or of any of its Affiliates.

### 3. ADMINISTRATION.

**(a) Administration by Board.** The Board shall administer the Plan unless and until the Board delegates administration to a Committee, as provided in Section 3(c). Whether or not the Board has delegated administration, the Board shall have the final power to determine all questions of policy and expediency that may arise in the administration of the Plan.

**(b) Powers of Board.** The Board (or the Committee) shall have the power, subject to, and within the limitations of, the express provisions of the Plan:

**(i)** To determine from time to time which of the persons eligible under the Plan shall be granted Stock Awards; when and how each Stock Award shall be granted; what type or combination of types of Stock Award shall be granted; the provisions of each Stock Award granted (which need not be identical), including the time or times when a person shall be permitted to receive Ordinary Shares pursuant to a Stock Award; and the number of Ordinary Shares with respect to which a Stock Award shall be granted to each such person.

**(ii)** To construe and interpret the Plan and Stock Awards granted under it, and to establish, amend and revoke rules and regulations for its administration. The Board, in the exercise of this power, may correct any defect, omission or inconsistency in the Plan or in any Stock Award Agreement, in a manner and to the extent it shall deem necessary or expedient to make the Plan fully effective.

**(iii)** To amend the Plan or a Stock Award as provided in Section 13.

**(iv)** Generally, to exercise such powers and to perform such acts as the Board deems necessary or expedient to promote the best interests of the Company that are not in conflict with the provisions of the Plan.

**(c) Delegation to Committee.** The Board may delegate administration of the Plan to a Committee of two (2) or more members of the Board, each of whom must qualify as a Non-Employee Director, Outside Director, and Independent Director. If administration is delegated to such a Committee, the Committee shall have, in connection with the administration of the Plan, the powers theretofore possessed by the Board, including the power to delegate to a subcommittee any of the administrative powers the Committee is authorized to exercise (and references in this Plan to the Board shall thereafter be deemed to be to the Committee or subcommittee, as appropriate), subject, however, to such resolutions, not inconsistent with the provisions of the Plan, as may be adopted from time to time by the Board. The Board may abolish the Committee, or any subcommittee, at any time and revert in the Board the administration of the Plan.

**(d) Effect of Board’s Decision.** All determinations, interpretations and constructions made by the Board in good faith shall not be subject to review by any person and shall be final, binding and conclusive on all persons.

#### 4. SHARES SUBJECT TO THE PLAN.

**(a) Share Reserve.** Subject to the provisions of Section 12 relating to adjustments upon changes in Ordinary Shares, the Ordinary Shares that may be issued pursuant to Stock Awards shall not exceed in the aggregate 25,000,000 Ordinary Shares, inclusive of the number of Former Plan Shares (as defined below).

**(b) Reversion of Shares and Availability of Shares to the Share Reserve.** If any Stock Award granted under the Plan or under the Former Plan shall for any reason expire or otherwise terminate, in whole or in part, without having been exercised in full, or if any Ordinary Shares issued to a Participant pursuant to a Stock Award granted under the Plan or under the Former Plan are forfeited back to or repurchased by the Company, including, but not limited to, any repurchase or forfeiture caused by the failure to meet a contingency or condition required for the vesting or exercise of such shares, then the Ordinary Shares not acquired under such Stock Award (the “Former Plan Shares”), shall become available for issuance under the Plan. Former Plan Shares shall include reserved Ordinary Shares that are not subject to a grant under the Former Plan. The number of Ordinary Shares underlying a Stock Award not issued as a result of any of the following actions shall again be available for issuance under the Plan: (i) a payout of a Stand-Alone Stock Appreciation Right, or a performance-based award of Restricted Stock or Restricted Stock Units in the form of cash; (ii) a cancellation, termination, expiration, forfeiture, or lapse for any reason (with the exception of the termination of a Tandem Stock Appreciation Right upon exercise of the related Options, or the termination of a related Option upon exercise of the corresponding Tandem Stock Appreciation Right) of any Stock Award; or (iii) payment of the Option exercise price and/or payment of any taxes arising upon exercise of the Option by withholding Ordinary Shares which otherwise would be acquired on exercise or issued upon such payout.

**(c) Source of Shares.** The Ordinary Shares subject to the Plan may be unissued shares or reacquired shares, bought on the market or otherwise.

#### 5. ELIGIBILITY.

**(a) Eligibility for Specific Stock Awards.** Incentive Stock Options may be granted only to Employees. Stock Awards other than Incentive Stock Options may be granted to Eligible Recipients.

**(b) Ten Percent Shareholders.** A Ten Percent Shareholder shall not be granted an Incentive Stock Option unless the exercise price of such Option is at least one hundred ten percent (110%) of the Fair Market Value of the Ordinary Shares at the date of grant and the Option is not exercisable after the expiration of five (5) years from the date of grant.

**(c) Consultants and Eligible Trusts.** A Consultant or Eligible Trust shall not be eligible for the grant of a Stock Award if, at the time of grant, a Form S-8 Registration Statement under the Securities Act (“Form S-8”) is not available to register either the offer or the sale of the Company’s securities to such Consultant or Eligible Trust because of the nature of the services that the Consultant is providing to the Company, or because the Consultant or Eligible Trust is not a natural person, or as otherwise provided by the rules governing the use of Form S-8, unless the Company determines both (i) that such grant (A) shall be registered in another manner under the Securities Act (e.g., on a Form F-3 Registration Statement) or (B) does not require registration under the Securities Act in order to comply with the requirements of the Securities Act, if applicable, and (ii) that such grant complies with the securities laws of all other relevant jurisdictions. Form S-8 generally is available to consultants and advisors only if (i) they are natural persons, (ii) they provide bona fide services to the issuer, its parents, its majority-owned subsidiaries or majority-owned subsidiaries of the issuer's parent, and (iii) the services are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the issuer’s securities.

**(d) Foreign Participants.** Notwithstanding any provision of the Plan to the contrary, in order to comply with the laws in other countries in which the Company and its subsidiaries operate or have Employees, Directors or Consultants, the Board, in its sole discretion, shall have the power and authority to: (i) determine which subsidiaries shall be covered by the Plan; (ii) determine which Employees, Directors or Consultants outside the

United States are eligible to participate in the Plan; (iii) modify the terms and conditions of any Stock Award granted to Employees, Directors or Consultants outside the United States to comply with applicable foreign laws; (iv) establish subplans and modify exercise procedures and other terms and procedures, to the extent such actions may be necessary or advisable (any such subplans and/or modifications shall be attached to this subplan as appendices); provided, however, that no such subplans and/or modifications shall increase the number of shares reserved for the Plan as set forth in Section 4 of the Plan; and (v) take any action, before or after a Stock Award is made, that it deems advisable to obtain approval or comply with any applicable foreign laws.

## 6. OPTION PROVISIONS.

Each Option shall be in such form and shall contain such terms and conditions as the Board shall deem appropriate. All Options shall be separately designated Incentive Stock Options or Nonstatutory Stock Options at the time of grant, and, if certificates are issued, a separate certificate or certificates will be issued for Ordinary Shares purchased on exercise of each type of Option. The provisions of separate Options need not be identical, but each Option shall include (through incorporation of provisions hereof by reference in the Option Agreement or otherwise) the substance of each of the following provisions:

**(a) Term.** Subject to the provisions of Section 5(b) regarding Ten Percent Shareholders, no Option shall be exercisable after the expiration of ten (10) years from the date it was granted.

**(b) Exercise Price of an Incentive Stock Option.** Subject to the provisions of Section 5(b) regarding Ten Percent Shareholders, the exercise price of each Incentive Stock Option shall be not less than one hundred percent (100%) of the Fair Market Value of the Ordinary Shares subject to the Option on the date the Option is granted. Notwithstanding the foregoing, an Incentive Stock Option may be granted with an exercise price lower than that set forth in the preceding sentence if such Option is granted pursuant to an assumption or substitution for another option in a manner satisfying the provisions of Section 424(a) of the Code.

**(c) Exercise Price of a Nonstatutory Stock Option.** The exercise price of Nonstatutory Stock Options shall be determined by the Board. However, the exercise price of each Nonstatutory Stock Option that is intended to qualify as performance-based compensation within the meaning of the Treasury Regulations promulgated under Section 162(m) of the Code shall be not less than one hundred percent (100%) of the Fair Market Value of the Ordinary Shares subject to the Option on the date the Option is granted.

**(d) Consideration.** The purchase price of Ordinary Shares acquired pursuant to an Option shall be paid, to the extent permitted by applicable statutes and regulations, either (i) in cash at the time the Option is exercised, or (ii) at the discretion of the Board at the time of the grant of the Option (or subsequently in the case of a Nonstatutory Stock Option) (A) by delivery to the Company of other Ordinary Shares, (B) according to a deferred payment or other similar arrangement with the Optionholder, (C) pursuant to a cashless exercise program implemented by the Company in connection with the Plan, or (D) in any other form of legal consideration that may be acceptable to the Board. Unless otherwise specifically provided in the Option Agreement, the purchase price of Ordinary Shares acquired pursuant to an Option that is paid by delivery to the Company of other Ordinary Shares acquired, directly or indirectly from the Company, shall be paid only by shares of the Ordinary Shares of the Company that have been held for more than six (6) months (or such longer or shorter period of time required to avoid a charge to earnings for financial accounting purposes).

In the case of any deferred payment arrangement, interest shall be compounded at least annually and shall be charged at the minimum rate of interest necessary to avoid the treatment as interest, under any applicable provisions of the Code, of any amounts other than amounts stated to be interest under the deferred payment arrangement.

**(e) Transferability of an Incentive Stock Option.** An Incentive Stock Option shall not be transferable except by will or by the laws of descent and distribution and shall be exercisable during the lifetime of the Optionholder only by the Optionholder. Notwithstanding the foregoing, the Optionholder may, by delivering written notice to the Company, in a form satisfactory to the Company, designate a third party who, in the event of the death of the Optionholder, shall thereafter be entitled to exercise the Option.

**(f) Transferability of a Nonstatutory Stock Option.** A Nonstatutory Stock Option shall be transferable only to the extent provided in the Option Agreement (subject to applicable securities laws). Notwithstanding the foregoing, the Optionholder may, by delivering written notice to the Company, in a form satisfactory to the Company, designate a third party who, in the event of the death of the Optionholder, shall thereafter be entitled to exercise the Option.

**(g) Vesting Generally.** The total number of Ordinary Shares subject to an Option may, but need not, vest and therefore become exercisable in periodic installments that may, but need not, be equal. The Option may be subject to such other terms and conditions on the time or times when it may be exercised (which may be based on performance or other criteria) as the Board may deem appropriate. The vesting provisions of individual Options may vary. The provisions of this Section 6(g) are subject to any Option provisions governing the minimum number of Ordinary Shares as to which an Option may be exercised.

**(h) Termination of Continuous Service.** In the event an Optionholder's Continuous Service terminates (other than upon the Optionholder's death or Disability), the Optionholder may exercise his or her Option (to the extent that the Optionholder was entitled to exercise such Option as of the date of termination) but only within such period of time ending on the earlier of (i) the date three (3) months following the termination of the Optionholder's Continuous Service (or, except with respect to Incentive Stock Options, such longer or shorter period specified in the Option Agreement), or (ii) the expiration of the term of the Option as set forth in the Option Agreement. If, after termination, the Optionholder does not exercise his or her Option within the time specified in the Option Agreement, the Option shall terminate.

**(i) Extension of Termination Date.** Except with respect to Incentive Stock Options, an Optionholder's Option Agreement may also provide that if the exercise of the Option following the termination of the Optionholder's Continuous Service (other than upon the Optionholder's death or Disability) would be prohibited at any time solely because the issuance of Ordinary Shares would violate the registration requirements under the Securities Act, then the Option shall terminate on the earlier of (i) the expiration of the term of the Option set forth in Section 6(a), or (ii) the expiration of a period of three (3) months after the termination of the Optionholder's Continuous Service during which the exercise of the Option would not be in violation of such registration requirements.

**(j) Disability of Optionholder.** In the event that an Optionholder's Continuous Service terminates as a result of the Optionholder's Disability, the Optionholder may exercise his or her Option (to the extent that the Optionholder was entitled to exercise such Option as of the date of termination), but only within such period of time ending on the earlier of (i) the date twelve (12) months following such termination (or, except with respect to Incentive Stock Options, such longer or shorter period specified in the Option Agreement) or (ii) the expiration of the term of the Option as set forth in the Option Agreement. If, after termination, the Optionholder does not exercise his or her Option within the time specified herein, the Option shall terminate.

**(k) Death of Optionholder.** In the event (i) an Optionholder's Continuous Service terminates as a result of the Optionholder's death or (ii) the Optionholder dies within the period (if any) specified in the Option Agreement after the termination of the Optionholder's Continuous Service for a reason other than death, then the Option may be exercised (to the extent the Optionholder was entitled to exercise such Option as of the date of death) by the Optionholder's estate, by a person who acquired the right to exercise the Option by bequest or inheritance or by a person designated to exercise the option upon the Optionholder's death pursuant to Section 6(e) or 6(f), but only within the period ending on the earlier of (A) the date eighteen (18) months following the date of death (or, except with respect to Incentive Stock Options, such longer or shorter period specified in the Option Agreement) or (B) the expiration of the term of such Option as set forth in the Option Agreement. If, after death, the Option is not exercised within the time specified herein, the Option shall terminate.

**(l) Early Exercise.** The Option may, but need not, include a provision whereby the Optionholder may elect at any time before the Optionholder's Continuous Service terminates to exercise the Option as to any part or all of the Ordinary Shares subject to the Option prior to the full vesting of the Option. The early purchase of any unvested Ordinary Shares will be pursuant to an early exercise provision in the Option Agreement which may



provide for a repurchase option in favor of the Company and other restrictions the Board determines to be appropriate. Any repurchase option so provided for will be subject to the repurchase provisions set forth in Section 11(h) herein.

**(m) Substitution of Stock Appreciation Rights for Options.** If the Company is required to or elects to expense the cost of Options pursuant to FAS 123 (or a successor or other standard), the Board shall have the sole discretion to substitute without receiving Participants' permission, Stock Appreciation Rights paid only in stock for outstanding Options; provided, the terms of the substituted Stock Appreciation Rights are substantially the same as the terms of the Options, the number of shares underlying the number of Stock Appreciation Rights equals the number of shares underlying the Options and the difference between the Fair Market Value of the underlying Ordinary Shares and the grant price of the Stock Appreciation Rights is equivalent to the difference between the Fair Market Value of the underlying Ordinary Shares and the exercise price of the Options.

**(n) Re-Load Options.**

**(i)** Without in any way limiting the authority of the Board to make or not to make grants of Options hereunder, the Board shall have the authority (but not an obligation) to include as part of any Option Agreement a provision entitling the Optionholder to a further Option (a "*Re-Load Option*") in the event the Optionholder exercises the Option evidenced by the Option Agreement, in whole or in part, by surrendering other Ordinary Shares in accordance with this Plan and the terms and conditions of the Option Agreement. Unless otherwise specifically provided in the Option Agreement, the Optionholder shall not surrender Ordinary Shares acquired, directly or indirectly from the Company, unless such shares have been held for more than six (6) months (or such longer or shorter period of time required to avoid a charge to earnings for financial accounting purposes).

**(ii)** Any such Re-Load Option shall (i) provide for a number of Ordinary Shares equal to the number of Ordinary Shares surrendered as part or all of the exercise price of such Option, (ii) have an expiration date which is the same as the expiration date of the Option the exercise of which gave rise to such Re-Load Option, and (iii) have an exercise price which is equal to one hundred percent (100%) of the Fair Market Value of the Ordinary Shares subject to the Re-Load Option on the date of exercise of the original Option. Notwithstanding the foregoing, a Re-Load Option shall be subject to the same exercise price and term provisions heretofore described for Options under the Plan.

Any such Re-Load Option may be an Incentive Stock Option or a Nonstatutory Stock Option, as the Board may designate at the time of the grant of the original Option; provided, however, that the designation of any Re-Load Option as an Incentive Stock Option shall be subject to the one hundred thousand dollar (\$100,000) annual limitation on the exercisability of Incentive Stock Options described in Section 11(d) of the Plan and in Section 422(d) of the Code. There shall be no Re-Load Options on a Re-Load Option. Any such Re-Load Option shall be subject to the availability of sufficient Ordinary Shares under Section 4(a) and shall be subject to such other terms and conditions as the Board may determine that are not inconsistent with the express provisions of the Plan regarding the terms of Options.

**7. PROVISIONS OF STOCK AWARDS OTHER THAN OPTIONS.**

**(a) Stock Bonus Awards.** Grants of stock bonus awards shall be pursuant to a Stock Award Agreement, which shall be in such form and shall contain such terms and conditions as the Board shall deem appropriate. The terms and conditions of each grant of a stock bonus award shall include (through incorporation of provisions hereof by reference in the Stock Award Agreement or otherwise) the substance of each of the following provisions:

**(i) Consideration.** A stock bonus may be awarded in consideration for past services rendered to the Company or an Affiliate for its benefit.

**(ii) Vesting; Right of Repurchase.** Ordinary Shares awarded under the Stock Award Agreement may, but need not, be subject to a share repurchase option in favor of the Company in accordance with a vesting schedule to be determined by the Board. Such repurchase option is subject to the repurchase provisions set forth in Section 11(h).

**(iii) Termination of Participant's Continuous Service.** In the event a Participant's Continuous Service terminates, the Company may reacquire any or all of the Ordinary Shares held by the Participant which have not vested as of the date of termination under the terms of the Stock Award Agreement. In such event, the Company shall not reacquire the Ordinary Shares until after the Repurchase Blackout Period.

**(iv) Transferability.** Rights to acquire Ordinary Shares under the Stock Award Agreement shall be transferable by the Participant only upon such terms and conditions as are set forth in the Stock Award Agreement, as the Board shall determine in its discretion, so long as Ordinary Shares awarded under the Stock Award Agreement remains subject to the terms of the Stock Award Agreement.

**(b) Restricted Stock and Restricted Stock Units.**

**(i) Designation.** Restricted Stock or Restricted Stock Units may be granted under the Plan. Restricted Stock or Restricted Stock Units may include a dividend equivalent right, as permitted by Section 12(a). After the Board determines that it will offer Restricted Stock or Restricted Stock Units, it will advise the Participant in writing or electronically, by means of a Stock Award Agreement, of the terms, conditions and restrictions, including vesting, if any, related to the offer, including the number of Ordinary Shares that the Participant shall be entitled to receive or purchase, the price to be paid, if any, and, if applicable, the time within which the Participant must accept the offer. The offer shall be accepted by execution of a Stock Award Agreement or as otherwise directed by the Board. The term of each award of Restricted Stock or Restricted Stock Units shall be at the discretion of the Board.

**(ii) Restrictions.** Subject to Section 8(b)(iii), the Board may impose such conditions or restrictions on the Restricted Stock or Restricted Stock Units granted pursuant to the Plan as it may determine advisable, including the achievement of specific performance goals, time based restrictions on vesting, or others. If the Board established performance goals, the Board shall determine whether a Participant has satisfied the performance goals.

**(iii) Performance Criteria.** Restricted Stock and Restricted Stock Units granted pursuant to the Plan that are intended to qualify as "performance based compensation" under Section 162(m) of the Code shall be subject to the attainment of performance goals relating to the Performance Criteria selected by the Board and specified at the time such Restricted Stock and Restricted Stock Units are granted. For purposes of this Plan, "*Performance Criteria*" means any one criterion or multiple criteria for measuring performance selected by the Board in its sole discretion, the measurement of which may be based upon Company, Subsidiary or business unit performance, or the individual performance of the Participant, either absolute or by relative comparison to other companies, other Participants or any other external measure of the selected criteria. Performance Criteria may include, without limitation, one or more of the following (as selected by the Board): (1) cash flow; (2) earnings per share; (3) earnings before interest, taxes, and amortization; (4) return on equity; (5) total shareholder return; (6) share price performance; (7) return on capital; (8) return on assets or net assets; (9) revenue; (10) revenue growth; (11) earnings growth; (12) operating income; (13) operating profit; (14) profit margin; (15) return on operating revenue; (16) return on invested capital; (17) operating efficiency; or (18) productivity.

**(iv) Transferability.** Restricted Stock and Restricted Stock Units shall be transferable by the Participant only upon such terms and conditions as are set forth in the Stock Award Agreement, as the Board shall determine in its discretion.

**(v) Vesting.** Unless the Board determines otherwise, the Stock Award Agreement shall provide for the forfeiture of the non-vested Ordinary Shares underlying Restricted Stock or the termination of unvested Restricted Stock Units upon termination of a Participant's Continuous Service. To the extent that the Participant purchased the Ordinary Shares granted under any such Restricted Stock award and any such Ordinary Shares remain non-vested at the time of termination of a Participant's Continuous Service, the termination of Participant's Continuous Service shall cause an immediate sale of such non-vested Ordinary Shares to the Company at the original price per share of Ordinary Shares paid by the Participant.

**(c) Stock Appreciation Rights.** Grants of Stock Appreciation Rights shall be pursuant to a Stock Award Agreement, which shall be in such form and shall contain such terms and conditions, as the Board shall deem

appropriate. The Board may grant Stock Appreciation Rights in connection with all or any part of an Option (“*Tandem Stock Appreciation Rights*”) to a Participant or in a stand-alone grant (“*Stand-Alone Stock Appreciation Rights*”). The terms and conditions of a Stock Appreciation Right shall include (through incorporation of the provisions hereof by reference in the Stock Award Agreement or otherwise) the substance of each of the following provisions:

**(i) Calculation of Appreciation.** Each Stock Appreciation Right will be denominated in Ordinary Shares equivalents. The appreciation distribution payable on the exercise of a Stock Appreciation Right will be not greater than an amount equal to the excess of (A) the aggregate Fair Market Value (on the date of the exercise of the Stock Appreciation Right) of a number of Ordinary Shares equal to the number of share of Ordinary Shares equivalents in which the Participant is vested under such Stock Appreciation Right and with respect to which the Participant is exercising the Stock Appreciation Right on such date, over (B) an amount that will be determined by the Board at the time of grant of the Stock Appreciation Right (which amount, in the case of Stock Appreciation Rights intended to qualify as performance-based compensation within the meaning of the Treasury Regulations under Section 162(m) of the Code, shall be not less than the Fair Market Value of such Ordinary Shares at the time of grant of the Ordinary Shares equivalents).

**(ii) Vesting.** At the time of the grant of a Stock Appreciation Right, the Board may impose such restrictions or conditions to the vesting of such Stock Appreciation Right as it deems appropriate.

**(iii) Exercise.** To exercise any outstanding Stock Appreciation Right, the Participant must provide written notice of exercise to the Company in compliance with the provisions of the Stock Award Agreement evidencing such Stock Appreciation Right.

**(iv) Payment.** The appreciation distribution in respect of a Stock Appreciation Right may be paid in Ordinary Shares, in cash, or any combination of the two, as the Board deems appropriate.

**(v) Termination of Continuous Service.** If a Participant’s Continuous Service terminates for any reason, any unvested Stock Appreciation Rights shall be forfeited and any vested Stock Appreciation Rights shall be automatically redeemed.

**(vi) Transferability.** Stock Appreciation Rights shall be transferable by the Participant only upon such terms and conditions as are set forth in the Stock Award Agreement, as the Board shall determine in its discretion.

**(vii) Tandem Stock Appreciation Rights.** A Tandem Stock Appreciation Right shall be exercisable only to the extent that the related Option is exercisable and a Tandem Stock Appreciation Right shall expire no later than the date on which the related Option expires.

## **8. COVENANTS OF THE COMPANY.**

**(a) Availability of Shares.** During the terms of the Stock Awards, the Company shall keep available at all times the number of Ordinary Shares required to satisfy such Stock Awards.

**(b) Securities Law Compliance.** The Company shall seek to obtain from each regulatory commission or agency having jurisdiction over the Plan such authority as may be required to grant Stock Awards and to issue and sell Ordinary Shares upon exercise of the Stock Awards; provided, however, that this undertaking shall not require the Company to register under the Securities Act the Plan, any Stock Award or any Ordinary Shares issued or issuable pursuant to any such Stock Award. If, after reasonable efforts, the Company is unable to obtain from any such regulatory commission or agency the authority which counsel for the Company deems necessary for the lawful issuance and sale of Ordinary Shares under the Plan, the Company shall be relieved from any liability for failure to issue and sell Ordinary Shares upon exercise of such Stock Awards unless and until such authority is obtained.

## **9. USE OF PROCEEDS FROM STOCK.**

Proceeds from the sale of Ordinary Shares pursuant to Stock Awards shall constitute general funds of the Company.

## 10. EFFECTIVE DATE OF PLAN.

The Plan shall become effective as determined by the Board, but no Stock Award shall be exercised (or, in the case of a stock bonus, shall be granted) unless and until the Plan has been approved by the shareholders of the Company, which approval shall be within twelve (12) months before or after the date the Plan is adopted by the Board.

## 11. MISCELLANEOUS.

**(a) Acceleration of Exercisability and Vesting.** The Board shall have the power to accelerate the time at which a Stock Award may first be exercised or the time during which a Stock Award or any part thereof will vest in accordance with the Plan, notwithstanding the provisions in the Stock Award stating the time at which it may first be exercised or the time during which it will vest.

**(b) Shareholder Rights.** No Participant shall be deemed to be the holder of, or to have any of the rights of a holder with respect to, any Ordinary Shares subject to such Stock Award unless and until such Participant has satisfied all requirements for exercise of the Stock Award pursuant to its terms.

**(c) No Employment or other Service Rights.** Nothing in the Plan or any instrument executed or Stock Award granted pursuant thereto shall confer upon any Participant any right to continue to serve the Company or an Affiliate in the capacity in effect at the time the Stock Award was granted or shall affect the right of the Company or an Affiliate to terminate (i) the employment of an Employee with or without notice and with or without cause, (ii) the service of a Consultant pursuant to the terms of such Consultant's agreement with the Company or an Affiliate, or (iii) the service of a Director pursuant to the Bylaws of the Company or an Affiliate, and any applicable provisions of the corporate law of the state in which the Company or the Affiliate is incorporated, as the case may be.

**(d) Incentive Stock Option \$100,000 Limitation.** To the extent that the aggregate Fair Market Value (determined at the time of grant) of Ordinary Shares with respect to which Incentive Stock Options are exercisable for the first time by any Optionholder during any calendar year (under all plans of the Company and its Affiliates) exceeds one hundred thousand dollars (\$100,000), the Options or portions thereof which exceed such limit (according to the order in which they were granted) shall be treated as Nonstatutory Stock Options.

**(e) Maximum Award Amounts.** In no event shall a Participant receive a Stock Award or Stock Awards during any one (1) calendar year covering in the aggregate more than 2,000,000 Ordinary Shares.

**(f) Investment Assurances.** The Company may require a Participant, as a condition of exercising or acquiring Ordinary Shares under any Stock Award (i) to give written assurances satisfactory to the Company as to the Participant's knowledge and experience in financial and business matters and/or to employ a purchaser representative reasonably satisfactory to the Company who is knowledgeable and experienced in financial and business matters and that he or she is capable of evaluating, alone or together with the purchaser representative, the merits and risks of exercising the Stock Award, and (ii) to give written assurances satisfactory to the Company stating that the Participant is acquiring Ordinary Shares subject to the Stock Award for the Participant's own account and not with any present intention of selling or otherwise distributing the Ordinary Shares. The foregoing requirements, and any assurances given pursuant to such requirements, shall be inoperative if (1) the issuance of the Ordinary Shares upon the exercise or acquisition of Ordinary Shares under the Stock Award has been registered under a then currently effective registration statement under the Securities Act, or (2) as to any particular requirement, a determination is made by counsel for the Company that such requirement need not be met in the circumstances under the then applicable securities laws. The Company may, upon advice of counsel to the Company, place legends on stock certificates issued under the Plan as such counsel deems necessary or appropriate in order to comply with applicable securities laws, including, but not limited to, legends restricting the transfer of the Ordinary Shares.

**(g) Withholding Obligations.** To the extent provided by the terms of a Stock Award Agreement, the Participant may satisfy any federal, state or local tax withholding obligation relating to the exercise or acquisition of Ordinary Shares under a Stock Award by any of the following means (in addition to the Company's right to

withhold from any compensation paid to the Participant by the Company) or by a combination of such means: (i) tendering a cash payment, (ii) authorizing the Company to withhold Ordinary Shares from the Ordinary Shares otherwise issuable to the Participant as a result of the exercise or acquisition of Ordinary Shares under the Stock Award, provided, however, that no Ordinary Shares are withheld with a value exceeding the minimum amount of tax required to be withheld by law, or (iii) delivering to the Company owned and unencumbered Ordinary Shares.

**(h) Repurchase Provisions.** The Company shall exercise any repurchase option specified in the Stock Award by giving the holder of the Stock Award written notice of intent to exercise the repurchase option. Payment may be cash or cancellation of purchase money indebtedness for the Ordinary Shares. The terms of any repurchase option shall be specified in the Stock Award and may be either at Fair Market Value at the time of repurchase or at not less than the original purchase price.

**(i) Golden Parachute Taxes.** In the event that any amounts paid or deemed paid to a Participant under the Plan are deemed to constitute “excess parachute payments” as defined in Section 280G of the Code (taking into account any other payments made under the Plan and any other compensation paid or deemed paid to a Participant), or if any Participant is deemed to receive an “excess parachute payment” by reason of his or her vesting of Options pursuant to Section 12(c) herein, the amount of such payments or deemed payments shall be reduced (or, alternatively the provisions of Section 12(c) shall not act to vest options to such Participant), so that no such payments or deemed payments shall constitute excess parachute payments. provided, however, that if a Participant is subject to a separate agreement with the Company or an Affiliate which specifically provides that payments attributable to one or more forms of employee stock incentives or to payments made in lieu of employee stock incentives will not reduce any other payments under such agreement, even if it would constitute an excess parachute payment, or provides that the Participant will have the discretion to determine which payments will be reduced in order to avoid an excess parachute payment, then the limitations of this Section 11(l) will, to that extent, not apply. The determination of whether a payment or deemed payment constitutes an excess parachute payment shall be in the sole discretion of the Board.

**(j) Right to American Depository Shares (“ADSs”).** The Company may arrange, in its sole discretion, for any one or more Participants to receive ADSs rather than Ordinary Shares upon the exercise of Stock Awards, in which case, all references to “Ordinary Shares” in this Plan or any other document related to the Plan shall be deemed to reference the appropriate number of ADSs per Ordinary Share, as the context may require with respect to such Stock Awards.

**(k) Plan Unfunded.** The Plan shall be unfunded. Except for the Board’s reservation of a sufficient number of authorized shares to the extent required by law to meet the requirements of the Plan, the Company shall not be required to establish any special or separate fund or to make any other segregation of assets to assure payment of any Stock Award under the Plan.

## 12. Adjustments upon Changes in Stock.

**(a) Capitalization Adjustments.** In the event that any dividend or other distribution (whether in the form of cash, shares of the Ordinary Shares, other securities, or other property), recapitalization, stock split, reverse stock split, reorganization, merger, consolidation, split-up, spin-off, combination, repurchase, exchange of Ordinary Shares or other securities of the Company, or other change in the corporate structure of the Company affecting the Ordinary Shares occurs, the Board, in order to prevent diminution or enlargement of the benefits or potential benefits intended to be made available under the Plan, may, in its sole discretion, adjust the number and class of Ordinary Shares that may be delivered under the Plan and/or the number, class, and price of Ordinary Shares covered by each outstanding Stock Award. In lieu of the payment of a dividend the Board in its discretion may provide holders of Restricted Stock or Restricted Stock Units a dividend equivalent right, in the form of additional Ordinary Shares or units, with respect to the unvested Ordinary Shares or unvested units the Participant shall be entitled to receive or purchase.

**(b) Dissolution or Liquidation.** In the event of the proposed dissolution or liquidation of the Company, the Board will notify each Participant as soon as practicable prior to the effective date of such proposed transaction. To the extent it has not been previously exercised, a Stock Award will terminate immediately prior to the consummation of such proposed action.

**(c) Change in Control.** In the event of Change in Control, then, to the extent permitted by applicable law: (1) any surviving corporation may assume any Stock Awards outstanding under the Plan or may substitute similar stock awards (including an award to acquire the same consideration paid to the shareholders in the transaction described in this Section 12(c)) for those outstanding under the Plan, or (2) in the event any surviving corporation does not assume or continue such Stock Awards, or substitute similar stock awards for those outstanding under the Plan in accordance with the preceding clause, then the time during which such Stock Awards may be exercised automatically will be accelerated and become fully vested and exercisable immediately prior to the consummation of such transaction, and the Stock Awards shall automatically terminate upon consummation of such transaction if not exercised prior to such event.

**(d) No Limitations.** The grant of Stock Awards will in no way affect the Company's right to adjust, reclassify, reorganize or otherwise change its capital or business structure or to merge, consolidate, dissolve, liquidate or sell or transfer all or any part of its business or assets.

### **13. AMENDMENT OF THE PLAN AND STOCK AWARDS.**

**(a) Amendment of Plan.** The Board at any time, and from time to time, may amend the Plan. However, except as provided in Section 12 relating to adjustments upon changes in Ordinary Shares, no amendment shall be effective unless approved by the shareholders of the Company to the extent shareholder approval is necessary to satisfy the applicable requirements of Section 422 or 162(m) of the Code and the Treasury Regulations thereunder, Rule 16b-3 under the Exchange Act or any Nasdaq or securities exchange listing requirements. For purposes of clarity, any increase in the number of shares reserved for issuance hereunder in accordance with the provisions of Section 4(a) hereof shall not be deemed to be an amendment to the Plan.

**(b) Contemplated Amendments.** It is expressly contemplated that the Board may amend the Plan in any respect the Board deems necessary or advisable to provide eligible Employees with the maximum benefits provided or to be provided under the provisions of the Code and the regulations promulgated thereunder relating to Incentive Stock Options and/or to bring the Plan and/or Incentive Stock Options granted under it into compliance therewith.

**(c) No Impairment of Rights.** Rights under any Stock Award granted before amendment of the Plan shall not be impaired by any amendment of the Plan unless (i) the Company requests the consent of the Participant and (ii) the Participant consents in writing.

**(d) Amendment of Stock Awards.** The Board at any time, and from time to time, may amend the terms of any one or more Stock Awards; provided, however, that the rights under any Stock Award shall not be impaired by any such amendment unless (i) the Company requests the consent of the Participant and (ii) the Participant consents in writing.

### **14. TERMINATION OR SUSPENSION OF THE PLAN.**

**(a) Plan Term.** The Board may suspend or terminate the Plan at any time. Unless sooner terminated, the Plan shall terminate on the day before the tenth (10th) anniversary of the date the Plan is adopted by the Board or approved by the shareholders of the Company, whichever is later. No Stock Awards may be granted under the Plan while the Plan is suspended or after it is terminated.

**(b) No Impairment of Rights.** Suspension or termination of the Plan shall not impair rights and obligations under any Stock Award granted while the Plan is in effect except with the written consent of the Participant.

### **15. CHOICE OF LAW.**

The law of California shall govern all questions concerning the construction, validity and interpretation of this Plan, without regard to such state's conflict of laws rules

**SHARE PURCHASE AGREEMENT**

**BY AND AMONG**

**SILICON MOTION TECHNOLOGY CORPORATION**

**LAKE TAHOE INVESTMENT CORPORATION**

**FCI INC.**

**KWANG JUN YUN**

**AND**

**SHAREHOLDERS OF FCI INC.**

**DATED AS OF APRIL 18, 2007**

---

## TABLE OF CONTENTS

	<u>Page</u>
1. Definitions	1
2. Purchase of Purchased Shares	9
2.1 Purchase and Sale of Purchased Shares	9
2.2 Purchase Price	9
2.3 Net Asset Adjustment	9
2.4 Earn-Out	11
2.5 Delivery of Shares; Remittance of Consideration	12
3. Closing	13
3.1 Place of Closing	13
3.2 Effectiveness of the Closing	13
3.3 Documents	13
4. Ordinary Shares	13
4.1 Issuance	13
4.2 Registration	13
4.3 Restrictions on Transfer; Legends	13
5. Escrow Agreement	13
6. Representations and Warranties of Sellers	14
6.1 Organization, Authority and Qualification of Sellers	14
6.2 Ownership of the Purchased Shares	14
6.3 No Conflict	14
6.4 Consents and Approvals	14
6.5 Brokers	14
6.6 Residency	14
7. Representations and Warranties of the Company	15
7.1 Organization, Authority and Qualification of the Company	15
7.2 Capital Stock of the Company	15
7.3 Subsidiaries	16
7.4 Corporate Books and Records	16
7.5 No Conflict	16
7.6 Consents and Approvals	16
7.7 Financial Statements and Books and Records	16
7.8 No Undisclosed Liabilities	17
7.9 Accounts Receivable	17
7.10 Permits	17
7.11 Conduct in the Ordinary Course of Business; Absence of Certain Changes, Events and Conditions	17
7.12 Customers, Distributors and Suppliers	18
7.13 Related Party Transactions	18
7.14 Litigation	18
7.15 Compliance with Laws	19
7.16 Material Contracts	19
7.17 Intellectual Property	20
7.18 Real Property	21
7.19 Tangible Personal Property	21
7.20 Inventories	21
7.21 Assets	21
7.22 Employee Benefit Matters	21



	<u>Page</u>
7.23 Labor Matters	22
7.24 Taxes	22
7.25 Insurance	22
7.26 Environment	23
7.27 Product Liability and Product Warranty	23
7.28 Loan Agreements	23
7.29 Brokers	23
7.30 Full Disclosure	23
7.31 No Other Representations or Warranties	23
8. Representations and Warranties of Purchaser and Parent	24
8.1 Organization	24
8.2 Authority	24
8.3 Capitalization and Ordinary Shares	24
8.4 No Conflict	24
8.5 Consents and Approvals	25
8.6 Brokers	25
8.7 Investigation and Evaluation	25
8.8 SEC Filings; Financial Statements	25
8.9 Litigation	25
8.10 Books and Records	26
8.11 Undisclosed Liabilities	26
8.12 Absence of Changes	26
8.13 Availability of Funds	26
8.14 No Other Representations or Warranties	26
9. Covenants of Sellers and the Company	26
9.1 Conduct of Business	26
9.2 Access	27
9.3 Authorizations	27
9.4 Conditions	27
9.5 No Shop	27
10. Covenants of Purchaser and Parent	28
10.1 Conditions	28
10.2 Foreign Investment Report	28
10.3 Authorizations	28
10.4 Employees; Contingent Grants	28
10.5 Listing of Additional Shares	28
10.6 D&O Insurance	28
11. Conditions for the Benefit of Purchaser and Parent	29
11.1 Representations and Warranties	29
11.2 Fulfillment of Covenants	29
11.3 Third Party Authorizations	29
11.4 Employment Agreement	29
11.5 Escrow Agreement	29
11.6 Investment Agreements	29
11.7 Consensus; Preferred Conversion; Stock Options	29
11.8 Proprietary Information and Inventions Agreement	29
11.9 Resignation of Directors and Statutory Auditor	30
11.10 Opinion of Counsel	30
11.11 Non-Competition Agreements	30

	<u>Page</u>
12. Conditions for the Benefit of Sellers	30
12.1 Representations and Warranties	30
12.2 Fulfillment of Covenants	30
12.3 Grant of New Restricted Stock Units	30
12.4 Approvals and Consents	30
12.5 Employment Agreement	30
12.6 Non-Competition Agreements	30
12.7 Escrow Agreement	30
12.8 Investment Agreements	30
12.9 Replacement Option Agreement	30
13. Indemnification	31
13.1 Indemnification by Sellers for Representations and Warranties and Covenants of the Company	31
13.2 Threshold and Cap	31
13.3 Indemnification by Sellers for Representations and Warranties of Sellers	31
13.4 Indemnification by Purchaser and Parent for Their Representations and Warranties	31
13.5 Third-Party Claim Indemnification Procedure	31
13.6 Direct Claim Indemnification Procedure	33
13.7 Consequential Damages	34
13.8 Adjustments to Losses	34
13.9 No Right of Set-Off	34
14. Survival of Representations, Warranties, Covenants and Indemnification Obligations	34
14.1 General	34
14.2 Survival of Tax Liabilities	35
15. Term and Termination	35
15.1 Term	35
15.2 Termination	35
15.3 Effects of Termination	35
16. Miscellaneous	35
16.1 Election of Remedies	35
16.2 Expenses	36
16.3 Further Assurances	36
16.4 Entire Agreement	36
16.5 Incorporation by Reference	36
16.6 Modifications	36
16.7 Waiver	36
16.8 Assignment	37
16.9 Severability	37
16.10 Governing Law	37
16.11 Arbitration	37
16.12 Notices	37
16.13 Counterparts	38
16.14 Captions	38
16.15 Number and Gender	39
16.16 Confidentiality	39
16.17 Language	39
17. Parent Guarantee	39

## LIST OF EXHIBITS AND SCHEDULES

Exhibit 1.79	Parent Plan
Exhibit 2.2(d)	Form of Replacement Option Agreement
Exhibit 4.1	Form of Investment Agreement
Exhibit 5.1	Form of Escrow Agreement
Exhibit 10.4	Form of Restricted Stock Unit Agreement
Exhibit 11.4(a)	Form of Service Agreement of Kwang Jun Yun
Exhibit 11.4(b)	Form of Service Agreement of Sangwoo Han
Exhibit 11.7	Form of Transfer Agreement and Power of Attorney
Exhibit 11.8	Form of Proprietary Information and Inventions Agreement
Exhibit 11.9	Form of Resignation Letter
Exhibit 11.10	Form of Opinion of Counsel
Exhibit 11.11	Form of Non-Competition Agreement
Schedule A	Share Ownership
Schedule 1.45	Excluded Shareholders
Schedule 2.2(d)	Company Options
Schedule 2.2(f)	Purchase Price Allocations and Pro Forma Calculations
Schedule 6.3	No Conflict
Schedule 6.4	Consents and Approvals
Schedule 6.5	Brokers
Schedule 6.6	Residency
Schedule 7.1	Authority and Qualification of the Company
Schedule 7.2	Capital Stock of the Company; Contractual Obligations
Schedule 7.3	Subsidiaries
Schedule 7.6	Consents and Approvals
Schedule 7.7(a)	Financial Statements
Schedule 7.7(c)	Securitization Transactions and “Off-Balance Sheet Arrangements”
Schedule 7.7(d)	Projected Closing Balance Sheet
Schedule 7.8	Undisclosed Liabilities
Schedule 7.9	Accounts Receivable
Schedule 7.10	Permits
Schedule 7.11	Conduct in the Ordinary Course of Business; Absence of Certain Changes
Schedule 7.12	Customers, Distributors and Suppliers
Schedule 7.13	Related Party Transactions
Schedule 7.14	Litigation
Schedule 7.16(a)	Material Contracts
Schedule 7.17(a)	Intellectual Property
Schedule 7.18	Real Property
Schedule 7.19	Tangible Personal Property
Schedule 7.21(a)	Assets
Schedule 7.22	Employee Benefit Matters
Schedule 7.23	Labor Matters
Schedule 7.25	Insurance
Schedule 7.27	Product Liability and Product Warranty
Schedule 7.28	Loan Agreements
Schedule 7.29	Brokers
Schedule 8.3	Capitalization and Ordinary Shares
Schedule 8.5	Consents and Approvals
Schedule 9.1	Conduct of Business
Schedule 10.4.	Contingent Stock Grants
Schedule 11.11	Individuals to Execute Non-Competition Agreement

## SHARE PURCHASE AGREEMENT

SHARE PURCHASE AGREEMENT (this "**Agreement**") is entered into as of April 18, 2007, by and among Silicon Motion Technology Corporation, a corporation organized and existing under the laws of the Cayman Islands ("**Parent**"), Lake Tahoe Investment Corporation, a corporation organized and existing under the laws of the Cayman Islands and a wholly-owned subsidiary of Parent ("**Purchaser**"), FCI Inc., a corporation organized and existing under the laws of the Republic of Korea (the "**Company**"), Mr. Kwang Jun Yun (the "**Sellers' Representative**"), and the shareholders of the Company listed on *Schedule A* of this Agreement (collectively, "**Sellers**," and individually, "**Seller**").

### RECITALS

A. As of the date hereof, Sellers own the number of shares of common stock and preferred stock of the Company set forth opposite their respective names on *Schedule A*, which constitute all of the issued and outstanding shares of capital stock of the Company, other than the Excluded Shares and the Unvested Company In-the-Money Options (the "**Purchased Shares**").

B. Sellers wish to sell to Purchaser, and Purchaser wishes to purchase from Sellers, the Purchased Shares, upon the terms and subject to the conditions set forth herein. In addition, the holders of the Unvested Company In-the-Money Options wish to cancel, and Parent wishes to replace with new stock options of Parent all of the Unvested Company In-the-Money Options.

### AGREEMENT

INTENDING TO BE LEGALLY BOUND, and in consideration of the premises and the mutual representations, warranties, covenants and agreements in this Agreement, the parties hereby agree as follows:

#### 1. *Definitions.*

For purposes of this Agreement, the following terms shall have the following meanings, unless the context clearly requires otherwise:

1.1 "**ADS Appreciation Ratio**" shall mean a percentage determined by multiplying 0.9 by the difference between (i) the quotient obtained by dividing the average of the regular session closing prices of Parent's American Depositary Shares for the twenty (20) trading days after the announcement of Parent's fourth quarter, fiscal year 2007 earnings results by US\$24.05 and (ii) one (1). If the foregoing product results in a negative number, then the ADS Appreciation Ratio shall be zero (0).

1.2 "**Action**" shall mean any civil, criminal, regulatory or administrative claim, action, suit, arbitration, proceeding or investigation by or before any court or other Governmental Authority or any arbitration proceeding.

1.3 "**Adjusted Cash Consideration**" shall mean the Cash Consideration less the payments made to the Company Special Shareholders pursuant to Section 2.2(a).

1.4 "**Adjusted Company Common Share Equivalents**" shall mean the Company Common Share Equivalents less (i) the Company Common Shares issuable upon cash exercise of all of the Unvested Company In-the-Money Options and (ii) the Company Common Shares held by the Company Special Shareholders.

1.5 "**Adjusted Korean GAAP**" shall mean generally accepted accounting principles and practices as in effect from time to time in Korea, provided, however, that any gross revenue from a sale of product or service to a Distributor of the Company shall be recognized at the time of resale thereof to an end-customer.

1.6 “**Ancillary Agreements**” shall mean the Investment Agreement, Escrow Agreement, and Employment Agreements.

1.7 “**Assets**” shall have the meaning set forth in Section 7.21(a).

1.8 “**Audited Financial Statements**” shall mean the financial statements of the Company, consisting of audited balance sheets and statements of income and cash flow of the Company, audited by independent public accountants, in accordance with generally accepted auditing standards in Korea, for its fiscal years ended as of December 31, 2004, December 31, 2005 and December 31, 2006, respectively.

1.9 “**BOK Reports**” shall mean any and all consents, approvals or authorizations of, filings with or notifications to the Bank of Korea required or necessary to be obtained, given or made for the consummation of the transactions contemplated by this Agreement and the Ancillary Agreements.

1.10 “**Business**” shall mean the business of the development and sale of products and services based on RF and derivative Intellectual Property technology, which have been conducted by the Company on or prior to the date hereof.

1.11 “**Cash Consideration**” shall mean five-ninth (5/9) of the Purchase Price.

1.12 “**Closing**” shall mean the consummation of all of the transactions as contemplated by Sections 2, 3 and 4.

1.13 “**Closing Adjustment Amount**” shall have that meaning set forth in Section 2.3(a).

1.14 “**Closing Balance Sheet**” shall mean the balance sheet (including the related notes and schedules thereto) of the Company as of the Closing Date, to be prepared based on the Projected Closing Balance Sheet in accordance with the Adjusted Korean GAAP pursuant to Section 7.7(d) and delivered to Purchaser three (3) days prior to the Closing.

1.15 “**Closing Date**” shall mean April 26, 2007, or such other date as may be agreed in writing by Purchaser and the Sellers’ Representative.

1.16 “**Closing Net Asset Value**” shall be the Net Assets of the Company set forth on the Final Closing Balance Sheet.

1.17 “**Company Accounting Firm**” shall mean Deloitte & Touche LLP.

1.18 “**Company Common Shares**” shall mean the common shares of the Company.

1.19 “**Company Common Share Equivalents**” shall mean all of (a) the Company Common Shares, (b) the Company Common Shares issuable on conversion of all of the Company Preferred Shares assuming conversion into the Company Common Shares at the conversion ratio of one (1) to one and one-fifth ( $1\frac{1}{5}$ ), and (c) the Company Common Shares issuable upon cash exercise of all of the Unvested Company In-the-Money Options.

1.20 “**Closing Net Asset Statement**” shall have the same meaning set forth in Section 2.3(b)

1.21 “**Company Option**” shall mean an option to purchase a Company Common Share.

1.22 “**Company Preferred Shares**” shall mean the preferred shares of the Company.

1.23 “**Company Shares**” shall mean the Company Common Shares and Company Preferred Shares.

1.24 “**Company Special Shareholders**” shall mean those Sellers who own less than forty thousand and one (40,001) Company Common Shares.

1.25 “**CPA Firm**” shall mean PricewaterhouseCoopers LLP or such other firm of independent certified public accountants of international recognition and standing, other than the respective auditors of Purchaser, Parent or the Company, as to which Sellers and Purchaser shall mutually agree.

1.26 “**Customer Offerings**” shall mean (a) the products that the Company or its subsidiary (i) currently develops, manufactures, markets, distributes, makes available, sells or licenses to third parties, (ii) has developed, manufactured, marketed, distributed, made available, sold or licensed to third parties within the previous three (3) years or (iii) currently is in the process of designing or developing, with plans to manufacture, market, distribute, make available, sell or license to third parties, and (b) the services that the Company or its subsidiary (i) currently provides or makes available to third parties, or (ii) has provided or made available to third parties within the previous three (3) years, or (iii) currently is in the process of developing and plans to provide or make available to third parties.

1.27 “**Debt**” shall mean all Indebtedness of the Company for any borrowed money.

1.28 “**Direct Claim**” and “**Direct Claim Notice**” shall have the respective meanings set forth in Section 13.6(a).

1.29 “**Disclosure Schedule**” shall have the meaning set forth in the introduction to Section 7.

1.30 “**Distributor**” shall mean any distributor of the relevant product or service of the Company, which purchases from the Company, and resell to end-customers, such product or service.

1.31 “**Earn-Out Amount**” shall mean Twelve Million U.S. Dollars (US\$12,000,000).

1.32 “**Earn-Out Dispute Notice**” shall have the meaning set forth on Section 2.4(c).

1.33 “**Earn-Out Statement**” shall have the meaning set forth on Section 2.4(b).

1.34 “**Employee Plan**” shall mean all bonus, stock option, stock purchase, restricted stock, incentive, deferred compensation, medical or life insurance, supplemental retirement, severance or other benefit plans, programs or arrangements, all employment rules or regulations, employee handbook, and all employment, termination, severance or other contracts, agreements or commitments (whether written or otherwise) to which the Company is a party or otherwise obligated, with respect to which the Company has any obligation or which are established, adopted, maintained, contributed to or sponsored by the Company for the benefit of any current or former employee, officer or director of the Company; *provided, however*, that the Employee Plan does not include any arrangement that has been terminated and completely wound up prior to the date of this Agreement and for which the Company has no present or potential liability.

1.35 “**Employment Agreements**” shall have the meaning set forth in Section 11.4.

1.36 “**Employee Stock Ownership Partnership**” or “**ESOP**” shall mean the employee stock ownership partnership of the Company.

1.37 “**Encumbrance**” shall mean any security interest, pledge, mortgage, lien (including, without limitation, environmental and tax liens), option, charge, encumbrance, claim, preferential arrangement or restriction of any kind, including without limitation any restriction on the use, voting, transfer, receipt of income or other exercise of any attributes of ownership.

1.38 “**Environmental Law**” shall mean any applicable Law relating to pollution, industrial hygiene, occupational safety conditions, environmental conditions, land use, water and air quality, Hazardous Materials and protection of the environment, health or safety (occupational, product related or otherwise).

1.39 “**Escrow**” shall have the meaning set forth in Section 5.

1.40 “**Escrow Agent**” shall have the meaning set forth in Section 5.

1.41 “**Escrow Agreement**” shall have the meaning set forth in Section 5.

1.42 “**Escrow Amount**” shall have the meaning set forth in Section 5.

1.43 “**Exchange Act**” shall mean the United States Securities and Exchange Act of 1934, as amended.

1.44 “**Exchange Rate**” shall mean the noon buying rate in New York City for cable transfers in Korean Won as certified for customs purposes by the Federal Reserve Bank of New York as of the day immediately prior to the date of this Agreement.

1.45 “**Excluded Shares**” shall mean (a) the Company Common Shares held by such members of the Employee Stock Ownership Partnership as set forth in *Schedule 1.45* and (b) the Company Shares held by the Non-Tendering Shareholders.

1.46 “**Financial Statements**” shall mean the Audited Financial Statements, the Interim Financial Statements and the Closing Balance Sheet.

1.47 “**Final Adjustment Amount**” shall have the meaning set forth in Section 2.3(b)

1.48 “**Final Closing Balance Sheet**” shall have the meaning set forth in Section 2.3(b)

1.49 “**Governmental Authority**” shall mean any Korean national, provincial or local or any foreign government, governmental, regulatory or administrative authority, agency or commission or any court, tribunal, or judicial or arbitral body or other bodies which exercise executive, legislative, judicial, regulatory or administrative functions of or pertaining to any Law.

1.50 “**Governmental Order**” shall mean any order, writ, judgment, injunction, decree, stipulation, determination or award entered by or with any Governmental Authority.

1.51 “**Hazardous Materials**” shall mean any substance, material or waste whether solid, liquid, gaseous or any combination of the foregoing which listed, defined, designated or otherwise classified as hazardous, toxic, radioactive or dangerous, or otherwise regulated, under any applicable Environmental Law, whether by type or by quantity, including any substance containing any such substance as a component, including, but not limited to, petroleum products, asbestos-containing materials, polychlorinated biphenyls, radon, urea formaldehyde insulation, and toxic mold.

1.52 “**Indebtedness**” shall mean, with respect to any Person; (a) all indebtedness of such Person, whether or not contingent, for borrowed money; (b) all obligations of such Person for the deferred purchase price of property or services; (c) all obligations of such Person evidenced by notes, bonds, debentures or other similar instruments; (d) all indebtedness created or arising under any conditional sale or other title retention agreement with respect to property acquired by such Person (even though the rights and remedies of the seller or lender under such agreement in the event of default are limited to repossession or sale of such property); (e) all obligations of such Person as lessee under leases that have been or should be, in accordance with Korean GAAP, recorded as capital leases; (f) all obligations, contingent or otherwise, of such Person under acceptance, letter of credit or similar

facilities; and (g) all Indebtedness of others referred to in clauses (a) through (f) above guaranteed directly or indirectly in any manner by such Person, or in effect guaranteed directly or indirectly by such Person through an agreement (i) to pay or purchase such Indebtedness or to advance or supply funds for the payment or purchase of such Indebtedness; (ii) to purchase, sell or lease (as lessee or lessor) property, or to purchase or sell services, primarily for the purpose of enabling the debtor to make payment of such Indebtedness or to assure the holder of such Indebtedness against loss; (iii) to supply funds to or in any other manner invest in the debtor (including any agreement to pay for property or services irrespective of whether such property is received or such services are rendered); or (iv) otherwise to assure a creditor against loss, and all Indebtedness referred to in clauses (a) through (f) above secured by (or for which the holder of such Indebtedness has an existing right, contingent or otherwise, to be secured by) any Encumbrance on property (including without limitation accounts and contract rights) owned by such Person, even though such Person has not assumed or become liable for the payment of such Indebtedness.

1.53 “**Indemnified Party**” and “**Indemnifying Party**” shall have the respective meanings set forth in Section 13.5(a).

1.54 “**Intellectual Property**” shall mean (a) inventions, whether or not patentable, whether or not reduced to practice, and whether or not yet made the subject of a pending patent application or applications; (b) ideas and conceptions of potentially patentable subject matter, including without limitation any patent disclosures, whether or not reduced to practice and whether or not yet made the subject of a pending patent application or applications; (c) national and multinational statutory invention registrations, patents, patent registrations and patent applications (including all reissues, divisions, continuations, continuations-in-part, extensions and reexaminations) and all rights therein provided by international treaties or conventions and all improvements to the inventions disclosed in each such registration, patent or application; (d) trademarks, service marks, trade dress, logos, trade names and corporate names, whether or not registered, including all common law rights, and registrations and applications for registration thereof, including without limitation all marks registered in the Korean Intellectual Property Office and in the trademark offices of other nations throughout the world, and all rights therein provided by international treaties or conventions; (e) copyrights (registered or otherwise) and registrations and applications for registration thereof, and all rights therein provided by international treaties or conventions; (f) computer software, including without limitation source code, operating systems and specifications, data, data bases, files, documentation and other materials related thereto, data and documentation; (g) trade secrets and confidential, technical and business information (including ideas, formulas, processes, compositions, inventions, and conceptions of inventions whether patentable or unpatentable and whether or not reduced to practice); (h) whether or not confidential, technology (including know-how), manufacturing and production processes and techniques, research and development information, drawings, specifications, designs, plans, proposals, technical data, copyrightable works, financial, marketing and business data, pricing and cost information, business and marketing plans and customer and supplier lists and information; (i) copies and tangible embodiments of all the foregoing, in whatever form or medium; (j) all rights to obtain and rights to apply for patents, and to register trademarks and copyrights; and (k) all rights to sue or recover and retain damages and costs and attorneys’ fees for present and past infringement of any of the foregoing.

1.55 “**Investment Agreement**” shall have the meaning set forth in Section 4.1.

1.56 “**Interim Financial Statements**” shall mean the unaudited balance sheet and statement of income of the Company for the period from January 1, 2007 to February 28, 2007, prepared in accordance with the Adjusted Korean GAAP.

1.57 “**Knowledge**” when used with respect to the Company, shall mean the actual knowledge, after due inquiry with the relevant department heads, of Kwang Jun Yun, Sangwoo Han and Insoo Kim.

1.58 “**Korea**” shall mean the Republic of Korea.

1.59 “**Korean GAAP**” shall mean generally accepted accounting principles and practices as in effect from time to time in Korea.



1.60 "**Law**" shall mean any national, provincial, local or foreign statute, law, ordinance, regulation, rule, code, order, other requirement or rule of law.

1.61 "**Leased Real Property**" shall mean the Real Property leased by the Company.

1.62 "**Liabilities**" shall mean any and all debts, liabilities and obligations of any nature, whether accrued or fixed, absolute or contingent, matured or unmatured, known or unknown, liquidated or unliquidated, or determined or determinable, including without limitation those arising under any Law, Action or Governmental Order and those arising under any contract, agreement, arrangement, commitment or undertaking.

1.63 "**Licensed Intellectual Property**" shall mean all Intellectual Property licensed or sublicensed to the Company from a third party.

1.64 "**Losses**" shall have the meaning set forth in Section 13.1.

1.65 "**Material Adverse Effect**" shall mean any circumstance, change in, or effect on the Business or the Company that, individually or together with a series of related circumstances, changes in, or effects on, the Business or the Company: (a) is materially adverse to the Business, Assets, Liabilities, prospects, results of operations or the condition (financial or otherwise) of the Company; or (b) would materially adversely affect the ability of Purchaser or the Company immediately following the Closing to operate or conduct the Business in the manner in which it is currently operated or conducted by Sellers or the Company, except for (i) any and all changes in general economic or political conditions, (so long as the Company is not disproportionately affected thereby), (ii) any and all matters affecting companies in the same or similar industries as the Business, and (iii) any effect of the public announcement of the transactions contemplated by this Agreement on customers or revenue of the Business.

1.66 "**Material Contracts**" shall mean the contracts and agreements (including without limitation oral and informal arrangements) of the Company described on Section 7.16(a) or listed in *Schedule 7.16(a)*, and all agreements relating to Intellectual Property set forth on *Schedule 7.17(a)*.

1.67 "**Net Assets**" shall have that meaning as ascribed under the Adjusted Korean GAAP.

1.68 "**Non-Disclosure Agreement**" shall mean the Non-Disclosure Agreement, dated as of March 14, 2007, by and between Parent and the Company.

1.69 "**Non-Tendering Shareholders**" shall mean the shareholders of the Company who do not tender their Company Common Shares at the Closing for sale to Purchaser pursuant to this Agreement.

1.70 "**Notice Period**" shall have meaning set forth in Section 13.5(b)

1.71 "**Ordinary Shares**" shall mean the ordinary shares, par value US\$0.01 per share, of Parent.

1.72 "**Ordinary Share Exchange Ratio**" shall have the meaning set forth in Section 2.2(c).

1.73 "**Option Consideration**" shall mean the aggregate exercise price, expressed in US Dollars based on the Exchange Rate, for all of the Unvested Company In-the-Money Options.

1.74 "**Option Exchange Ratio**" shall mean the quotient obtained by dividing the Per Share Consideration by \$6.0125.

1.75 "**Ordinary Course of Business**" or "**Ordinary Course**" shall mean the ordinary course of business of the Company, Parent or Purchaser, as the case may be, consistent with past custom and practice (including, if applicable, with respect to quantity, frequency and amount).

1.76 “**Ordinary Share Recipients**” mean the Sellers, including the holders of the Company Preferred Shares but excluding the Company Special Shareholders.

1.77 “**Owned Intellectual Property**” shall mean all Intellectual Property in and to which the Company holds all right, title and interest.

1.78 “**Parent Options**” shall mean options to purchase Ordinary Shares to be granted to the Parent Plan in replacement of Company Options.

1.79 “**Parent Plan**” shall mean the 2005 Parent Equity Incentive Plan of Parent as set forth in Exhibit 1.79.

1.80 “**Parent SEC Reports**” shall have the meaning as set forth in Section 8.8.

1.81 “**Party**” shall mean any of the parties hereto, and “**Parties**” shall mean all of the parties hereto.

1.82 “**Per Share Consideration**” shall mean the Purchase Price divided by the Company Common Share Equivalents.

1.83 “**Permits**” shall mean all licenses, consents, exemptions, approvals, registrations, permits, certificates and other authorizations from or by any Governmental Authority, and applications thereof.

1.84 “**Person**” shall mean any individual, partnership, firm, corporation, association, foundation, trust, unincorporated organization or other entity, including without limitation any Governmental Authority.

1.85 “**Post-Closing Adjustment Amount**” shall equal the Final Adjustment Amount minus the Closing Adjustment Amount; *provided, however*, that (i) if the Closing Adjustment Amount was a negative amount and less than Three Hundred Thousand U.S. Dollars (US\$300,000), then the Post-Closing Adjustment Amount shall be equal to the Final Adjustment Amount and (ii) if the Closing Adjustment Amount was a negative amount and more than Three Hundred Thousand U.S. Dollars (US\$300,000), then, for the purpose of this definition, the Closing Adjustment Amount shall be reduced by Three Hundred Thousand U.S. Dollars (US\$300,000) (e.g., if the Closing Adjustment Amount was a negative amount and Four Hundred Thousand U.S. Dollars (US\$400,000), then the Closing Adjustment Amount would be reduced to negative One Hundred Thousand U.S. Dollars (US\$100,000)). The Post-Closing Adjustment Amount can be either positive or negative.

1.86 “**Product Margin**” shall mean the quotient obtained by dividing Product Profits by Product Revenues, expressed as a percentage.

1.87 “**Product Margin Target**” shall mean for the year ending December 31, 2007, fifty three percent (53%).

1.88 “**Product Profits**” shall mean the Product Revenues minus the cost of wafer, assembly, testing and packing.

1.89 “**Product Revenues**” shall mean the total gross revenues of the Company; provided that any gross revenue from a sale of product or service to a Distributor of the Company shall be recognized at the time of resale thereof to an end-customer.

1.90 “**Projected Closing Balance Sheet**” shall have that meaning set forth in Section 7.7(d)

1.91 “**Purchase Price**” shall be Ninety Million U.S. Dollars (US\$90,000,000) plus (i) the Post-Closing Adjustment Amount, (ii) the Closing Adjustment Amount and (ii) the Option Consideration.

1.92 "**Purchased Shares**" shall have the meaning set forth in the Recital.

1.93 "**RF**" means radio frequency.

1.94 "**Real Property**" shall mean the real property owned or leased by the Company.

1.95 "**Registration Statement**" shall have the meaning set forth in Section 4.2.

1.96 "**Replacement Option**" shall have the meaning set forth in Section 2.2(d).

1.97 "**Replacement Option Agreement**" shall have the meaning set forth in Section 2.2(d).

1.98 "**Replacement Option Value**" shall mean the Per Share Consideration multiplied by the Unvested Company In-the-Money Options.

1.99 "**Revenue Target**" shall mean Product Revenues of the Company of Thirty-Three Million U.S. Dollars (US\$33,000,000) for calendar year ending December 31, 2007.

1.100 "**Securities Act**" shall mean the United States Securities Act of 1933, as amended.

1.101 "**Securities and Exchange Commission**" or "**SEC**" shall have the meaning set forth in Section 4.2.

1.102 "**Sellers' Objection**" shall have the meaning set forth in Section 2.3(c).

1.103 "**Sellers' Representative**" shall have the meaning set forth in the preamble to this Agreement.

1.104 "**Stock Consideration**" shall mean four-ninth (4/9) of the Purchase Price less the Replacement Option Value.

1.105 "**Tangible Personal Property**" shall have the meaning set forth in Section 7.19.

1.106 "**Tax**" shall mean, whether direct or indirect and whether levied by reference to income, profits, gains, net wealth, asset values, turnover, added value or other reference and statutory, governmental, state, provincial, local governmental or municipal impositions, duties, rates and levies, whenever and wherever imposed (whether imposed by way of a withholding or deduction for or on account of tax or otherwise) and in respect of any Person and all penalties, charges, costs and interest relating thereto.

1.107 "**Tax Authority**" shall mean any taxing or other authority competent to impose any liability in respect of Tax or responsible for the administration and/or collection of Tax or enforcement of any law in relation to Tax.

1.108 "**Third Party Claim**" and "**Third Party Claim Notice**" shall have the respective meanings set forth in Section 13.5(a).

1.109 "**Threshold**" shall have the meaning set forth in Section 13.2.

1.110 "**Unresolved Objection**" shall have the meaning set forth in Section 2.4(d).

1.111 "**Unvested Company In-the-Money Options**" shall be those unvested options to purchase Company Common Shares with an exercise price of less than the Per Share Consideration, calculated based on the Exchange Rate.

1.112 "**U.S. GAAP**" shall mean generally accepted accounting principles and practices as in effect from time to time in the United States.

## 2. Purchase of Purchased Shares.

2.1 *Purchase and Sale of Purchased Shares.* At the Closing and on the terms and subject to the conditions set forth in this Agreement, Sellers shall sell and deliver to Purchaser, and Purchaser shall purchase from Sellers and pay therefor, the Purchased Shares, free and clear of any and all Encumbrances and in suitable form for transfer to Purchaser.

2.2 *Purchase Price.* At the Closing, Purchaser and Parent shall jointly and severally pay the Purchase Price as follows:

(a) The Per Share Consideration shall be paid in cash to the Company Special Shareholders, on a per share basis.

(b) The Adjusted Cash Consideration shall be paid, on a per share basis, to Sellers other than the Company Special Shareholders.

(c) The Ordinary Shares shall be issued, as described in Section 4.1 below to the Ordinary Share Recipients. The number of Ordinary Shares issuable to the Ordinary Share Recipients per Company Common Share shall be equal to the amount obtained by (i) dividing the Stock Consideration by the Adjusted Company Common Share Equivalents and (ii) taking the quotient derived from clause (i) and dividing that by \$6.0125 (the “**Ordinary Share Exchange Ratio**”), and the number of Ordinary Shares to be issued to the Ordinary Share Recipients per Company Preferred Share shall be equal to the amount obtained by multiplying the (x) the Ordinary Share Exchange Ratio and (y) one point two (1.2).

(d) Parent Options shall be issued in replacement of Unvested Company In-the-Money Options. The number of Parent Options to be issued (the “**Replacement Options**”) shall be determined by multiplying the Unvested Company In-the-Money Options by the Option Exchange Ratio. The exercise price for the Replacement Options shall be determined by multiplying the then current exercise price for the Unvested Company In-the-Money Options by the Exchange Rate and dividing the resulting product by the Option Exchange Ratio. Parent Options issued pursuant to this Section 2.2(d) shall be issued pursuant to the Parent Plan and shall continue to vest as set forth in the form attached hereto as *Exhibit 2.2(d)* (the “**Replacement Option Agreement**”). *Schedule 2.2(d)* sets forth all of the outstanding Company Options, amount vested, amount expected to be vested on the Closing Date, and vesting schedule for each Company Option.

(e) No fraction of an Ordinary Share or Parent Option exercisable for a fraction of an Ordinary Share will be issued in the transactions contemplated by this Agreement. In lieu of such issuance, all Ordinary Shares issued to the Ordinary Share Recipients shall be rounded to the closest whole Ordinary Share, and the number of Ordinary Shares subject to any Parent Option shall be rounded to the nearest whole number of Ordinary Shares.

(f) *Schedule 2.2(f)* sets forth all of the Company Common Share Equivalents together with a pro-forma calculation of consideration to be paid pursuant to this Agreement. *Schedule 2.2(f)* shall be revised and updated as of the Closing Date reflecting any changes in Company Common Share Equivalents or the Purchase Price.

(g) The cash payments described herein shall be paid by Parent or Purchaser to the account specified in writing by the Sellers’ Representative no later than three (3) days prior to the Closing Date, and shall be distributed pursuant to the instructions delivered by the Sellers’ Representative.

### 2.3 *Net Asset Adjustment.*

(a) At least three (3) days prior to the Closing, Sellers shall prepare, or cause to be prepared, and deliver to Purchaser the Closing Balance Sheet. The Purchase Price shall be (i) decreased by the amount that

the Net Assets in such updated Projected Closing Balance Sheet is less than the Net Assets set forth on the Company's balance sheet as of December 31, 2006 or (ii) increased by the amount that the Net Assets in such updated Projected Closing Balance Sheet exceeds the Net Assets set forth on the Company's balance sheet as of December 31, 2006 (the "**Closing Adjustment Amount**") *provided, however*, that any such negative adjustment shall only be made to the extent such amount exceeds Three Hundred Thousand U.S. Dollars (US\$300,000), in which case the amount of the negative adjustment would be only the amount in excess of Three Hundred Thousand U.S. Dollars (US\$300,000).

(b) As soon as practicable, but in no event more than sixty (60) days, following the Closing, Purchaser shall prepare, or cause to be prepared, and deliver to the Sellers' Representative the "**Final Closing Balance Sheet**" of the Company as of the Closing, which shall be prepared in accordance with the Company's current accounting methods, policies, practices and procedures under the Adjusted Korean GAAP and in the same manner, with consistent classification and estimation methodology, as the Projected Closing Balance Sheet was prepared. Upon completion of the Final Closing Balance Sheet, Purchaser shall derive the Closing Net Asset Value from the Final Closing Balance Sheet, and deliver a statement of such calculation of the Final Adjustment Amount the Closing Net Asset Statement to the Sellers' Representative. The "**Final Adjustment Amount**" shall be the amount equal to Closing Net Asset Value minus the Net Assets set forth on the Company's balance sheet as of December 31, 2006.

(c) Sellers shall complete its review of the Final Closing Balance Sheet and Purchaser's calculation of the Closing Net Asset Value within thirty (30) days after delivery thereof to the Sellers' Representative by Purchaser. If the Sellers' Representative disputes all, any part or basis of the Closing Net Asset Statement, the Sellers' Representative shall, on or before the last day of such thirty (30)-day period, so inform Purchaser in writing (the "**Sellers' Objection**"), setting forth a description of the basis of Sellers' determination and proposed adjustments to the Closing Net Asset Statement and the corresponding adjustments to the Closing Net Asset Value that the Sellers' Representative believes should be made. If no Sellers' Objection is received by Purchaser on or before the last day of such thirty (30)day period, then the Closing Net Asset Value set forth on the Closing Net Asset Statement delivered by Purchaser shall be final, conclusive and binding upon the Parties. Purchaser shall have thirty (30) days from its receipt of the Sellers' Objection to review and respond to the Sellers' Objection.

(d) If Purchaser and the Sellers' Representative are unable to resolve all of their disagreements with respect to the proposed adjustments set forth in the Sellers' Objection within forty-five (45) days following Purchaser's receipt of the Sellers' Objection, they shall refer any remaining disagreements to the CPA Firm, which, acting as experts and not as arbitrators, shall determine, on the basis set forth in and in accordance with Section 2.3(a), and only with respect to the remaining differences so submitted, whether and to what extent, if any, the Closing Net Asset Statement and the Closing Net Asset Value require adjustment. Purchaser and the Sellers' Representative shall instruct the CPA Firm to deliver its written determination to Purchaser and the Sellers' Representative no later than thirty (30) days after the remaining differences underlying the Sellers' Objection are referred to the CPA Firm. The CPA Firm's determination shall be final, conclusive and binding upon Purchaser and Sellers. The fees and disbursements of the CPA Firm shall be borne equally by Purchaser and Sellers. Purchaser and Sellers shall make readily available to the CPA Firm all relevant books and records and any work papers (including those of the parties' respective accountants, to the extent permitted by such accountants) relating to the Closing Net Asset Statement and the Sellers' Objection and all other items reasonably requested by the CPA Firm in connection therewith.

(e) Sellers shall have full access to all information used by Purchaser in preparing the Closing Net Asset Statement, including the work papers of its accountants (to the extent permitted by such accountants).

(f) The Purchase Price shall be further adjusted by the Post-Closing Adjustment Amount. If the Post-Closing Adjustment Amount is a negative number in excess of Three Hundred Thousand U.S. Dollars (US\$300,000), then the Purchase Price shall be decreased by the Post-Closing Adjustment Amount to the

extent such amount is in excess of Three Hundred Thousand U.S. Dollars (US\$300,000) and Purchaser shall withdraw in cash after the final determination thereof this amount from the Escrow in accordance with the Escrow Agreement, without regard to any Threshold set forth in Section 13 hereof. If the Post-Closing Adjustment Amount is a positive number, then the Purchase Price shall be increased by the Post-Closing Adjustment Amount and Purchaser and Parent shall promptly (and in any event within one calendar week) after the final determination thereof pay to Sellers the Post-Closing Adjustment Amount in cash, without regard to any Threshold set forth in Section 13 hereof.

(g) Notwithstanding anything herein to the contrary, if the amount that would otherwise constitute the Post-Closing Adjustment Amount (as such Post-Closing Adjustment Amount, if a negative number, is reduced by Three Hundred Thousand U.S. Dollars (US\$300,000) pursuant to Section 2.3(f) is equal to or less than One Hundred Thousand U.S. Dollars (US\$100,000), no adjustment to the Purchase Price or the Cash Consideration shall be made and no Post-Closing Adjustment Amount shall be payable to Sellers or Purchaser/Parent, as the case may be.

#### 2.4 Earn-Out.

(a) In addition to the Purchase Price, if the Company meets or exceeds (i) the Revenue Target and (ii) the Product Margin Target, Purchaser shall pay in cash to Sellers, on a pro-rata basis, the Earn-Out Amount less the product of the Stock Consideration and the ADS Appreciation Ratio (the “**Earn-Out**”) exclusive of any Tax, fees or other expenses of any kind; *provided* that the exchange rate shall be fixed at the Exchange Rate for the calculation of the Earn-Out. The Earn-Out shall not exceed the Earn-Out Amount.

(b) Within ten (10) business days after the announcement date of Parent’s fourth quarter fiscal year 2007, Purchaser shall prepare, or cause to be prepared, and deliver to the Sellers’ Representative (i) a statement setting forth the Product Revenues for the calendar year 2007, each component used in the calculation thereof, the ADS Appreciation Ratio and the amount of the Earn-Out determined in accordance with Section 2.4(a) (the “**Earn-Out Statement**”), which shall be prepared in accordance with the Adjusted Korean GAAP, at Purchaser’s cost and expense, and (ii) such documentation, if any, as may be reasonably necessary to enable the Sellers’ Representative to determine such amount. Concurrently with the delivery of the Earn-Out Statement, Purchaser shall deposit into a nominated account as established by the Sellers’ Representative for payment to Sellers, on a per share basis, the amount of the Earn-Out, if any, specified in the Earn-Out Statement.

(c) After receipt from Purchaser of the Earn-Out Statement and, if applicable, the Earn-Out, Sellers shall have the right, at its cost and expense, and upon not less than seven (7) days’ prior written notice to Purchaser, to (i) meet with Purchaser and the Company Accounting Firm to discuss Purchaser’s calculation of the amount of the Product Revenues, the ADS Appreciation Ratio and the Earn-Out as set forth in the Earn-Out Statement and (ii) have reasonable access during normal business hours to inspect the books and records of the Company and working papers (including those prepared by advisors and other third parties, to the extent permitted thereby) relating to such calculation. If the Sellers’ Representative fails to challenge Purchaser’s determination of the Product Revenues, the ADS Appreciation Ratio and the amount of the Earn-Out by the delivery of a written notice to Purchaser (the “**Earn-Out Dispute Notice**”) within sixty (60) days after receipt by the Sellers’ Representative of the Earn-Out Statement, such determination by Purchaser shall be final, conclusive and binding for all purposes of this Agreement.

(d) In the event that Sellers disputes Purchaser’s determination of the amount of the Product Revenues, the ADS Appreciation Ratio and/or the amount of the Earn-Out, the Sellers’ Representative shall so notify Purchaser by delivering a Earn-Out Dispute Notice to Purchaser within the period set forth in Section 2.4(c) (the amount of any disputed Contingent Payment being referred to herein as the “*Disputed Contingent Payment*”). In the event of such a dispute, Sellers and Purchaser shall first use diligent, good faith efforts to resolve such dispute between them. If they are unable to resolve the dispute within thirty (30) days after the

delivery of the Earn-Out Dispute Notice, then the dispute shall be submitted to the CPA Firm for determination in accordance with the following provisions:

(i) Purchaser and the Sellers' Representative shall submit to the CPA Firm, within ten (10) days after the date of the engagement of the CPA Firm (as evidenced by the date of the engagement letter), copies of (A) the Earn-Out Statement, (B) the Earn-Out Dispute Notice and (C) a list of all unresolved objections raised by Sellers with respect to the calculation of the amount of the Earn-Out (the "**Unresolved Objections**"). Each of Purchaser and the Sellers' Representative shall submit to the CPA Firm (with a copy delivered to the other Party on the same day), within thirty (30) days after the date of the engagement of the CPA Firm, a memorandum (which may include supporting exhibits) setting forth their respective positions on the Unresolved Objections. Each of Purchaser and the Sellers' Representative may (but shall not be required to) submit to the CPA Firm (with a copy delivered to the other Party on the same day), within sixty (60) days after the date of the engagement of the CPA Firm, a memorandum responding to the initial memorandum submitted to the CPA Firm by the other Party. Unless requested by the CPA Firm in writing, neither Purchaser nor the Sellers' Representative may present any additional information or arguments to the CPA Firm, either orally or in writing; *provided, however*, that each party shall have the right to respond to the CPA Firm's requests directed to the other Party.

(ii) The CPA Firm shall prepare and distribute to the Parties a writing setting forth the CPA Firm's determination of the Unresolved Objections, the CPA Firm's reasons therefor and the amount of the Earn-Out calculated pursuant thereto; *provided, however*, that the CPA Firm shall not change nor deviate from the calculation of any item not specifically challenged in the Unresolved Objections. Any decision rendered by the CPA Firm shall be final, conclusive and binding upon the Parties, and judgment thereon may be entered and enforced in any court of competent jurisdiction.

(iii) The fees and expenses of the CPA Firm in connection with the resolution of disputes pursuant to this paragraph (d) shall be shared equally by Purchaser and Sellers; *provided, however*, that if the CPA Firm determines that one Party has adopted a position or positions that is or are frivolous or clearly without merit, the CPA Firm may, in its discretion, assign a greater portion of such fees and expenses to such Party.

(e) From the Closing Date through December 31, 2007, except as otherwise contemplated by this Agreement or as the Sellers' Representative otherwise agrees in writing in advance, Purchaser and Parent shall conduct, and shall cause its affiliates to conduct, the Business in the Ordinary Course of Business and use all commercially reasonable efforts to preserve intact the Business and its relationship with its customers, sales representatives, suppliers, Distributors, creditors, employees and other third parties with which the Company transacts business, shall use commercially reasonable efforts to maximize the Product Profits, the Product Revenues and the Product Margin during the year ending December 31, 2007, shall provide adequate financial and other supports to the Company in connection with the Business and shall not transfer out of the Business any Customer Offerings (or any derivative product therefrom) offered or planned to be offered by the Company as of the Closing; provided that in the event of any Customer Offering is bundled with another product which is not a product of the Business, such portion of gross revenues therefrom attributable to the Customer Offerings shall be included in the calculation of the Product Profits, the Product Revenues and the Product Margin.

**2.5 Delivery of Shares; Remittance of Consideration.** At the Closing, each Seller shall surrender such certificates or other documentation to Parent or Purchaser together with such other duly executed documentation as may be reasonably required by Parent, Purchaser or its counsel to effect a transfer of such shares to Purchaser. In addition, Ordinary Share Recipients shall be required to execute a counterpart of the Investment Agreement pursuant to Section 4.1 and such other documentation as may be reasonably required by Parent's share transfer agent.

### 3. Closing.

3.1 *Place of Closing.* The Closing shall be effected at the offices of Kim & Chang, 222 Naeja-dong, Jongno-gu, Seoul, Korea, or such other place as may be agreed in writing by Purchaser and the Sellers' Representative, on the Closing Date.

3.2 *Effectiveness of the Closing.* The Closing will be effective as of the close of business on the Closing Date, provided that all of the transactions contemplated by Sections 2.1, 2.2, 2.3(a), 2.5 and 3 have been consummated.

3.3 *Documents.* On the Closing Date, as described in Section 2.5, Sellers shall deliver to Purchaser the original stock certificates representing the Purchased Shares, in suitable form for transfer, and the Parties shall exchange and deliver the certificates, opinions and other documents required under this Agreement, together with such other documents as Purchaser's counsel and Sellers' counsel shall deem necessary to effect the Closing.

### 4. Ordinary Shares.

4.1 *Issuance.* On or prior to the Closing Date, each Ordinary Share Recipient shall execute and deliver to Parent, and Parent shall execute and deliver to each Ordinary Share Recipient, an investment agreement to Parent in the form attached hereto as *Exhibit 4.1* (the "**Investment Agreement**") under which Parent shall issue and sell to such Ordinary Share Recipient, and Sellers shall subscribe for and purchase, the Ordinary Shares as described in Section 2.2. At the Closing, Parent shall deliver (a) the portion of the Ordinary Shares corresponding to the Escrow Amount to the Escrow Agent according to the Escrow Agreement described in Section 5 below and (b) Ordinary Shares to the Ordinary Share Recipients in the amounts set forth on *Schedule 2.2(f)*.

4.2 *Registration.* Parent shall register the Ordinary Shares (and ADS representing such Ordinary Shares) issued pursuant to this Agreement and the Ordinary Shares (and ADS representing such Ordinary Shares) issuable pursuant to exercise of Replacement Options or the new restricted stock options of Parent to be granted pursuant to Section 10.4 with the United States Securities and Exchange Commission ("**SEC**") pursuant to the Securities Act (the "**Registration Statement**"). The purpose of such registration is to permit the resale of the Ordinary Shares in the United States by Sellers without restrictions imposed on the sale of "restricted securities" under the Securities Act. The registration will be effected by the filing of a registration statement with the SEC. The timing of registration and the rights and obligations of Parent and Ordinary Share Recipients with respect to such registration shall be governed by the Investment Agreement.

4.3 *Restrictions on Transfer; Legends.* Until the Registration Statement has been declared effective by the SEC pursuant to the Securities Act, Ordinary Share Recipients may not offer to sell, sell, contract to sell, pledge or otherwise transfer or dispose of, directly or indirectly, the Ordinary Shares other than pursuant to an available exemption from the registration requirements of the Securities Act. Share certificates representing shares of Ordinary Shares issued to the Ordinary Share Recipients will contain customary legends restricting the transfer of the Ordinary Shares and Parent will notify its transfer agent of such restrictions; which legends will be removed from an Ordinary Share certificate at the request of the relevant Ordinary Share Recipient or another holder thereof in connection with the proposed transfer thereof, including, in the case of the securities Laws legend, receipt by Parent of an opinion of counsel, in form and substance satisfactory to Parent, or a no-action letter from the SEC addressed to Parent, to the effect that registration under the Securities Act is unnecessary in respect of such proposed transfer, in reliance upon SEC Rule 144 or 145 or such other available exemption under the Securities Act, and that such legend is not required by law to appear on such certificate.

### 5. Escrow Agreement.

At the Closing, Parent, Purchaser, Sellers' Representative and the Escrow Agent shall enter into an escrow agreement in the form attached hereto as *Exhibit 5.1* (the "**Escrow Agreement**") with Citibank Korea (the "**Escrow Agent**") under which Ordinary Shares and cash having a value of Thirteen Million and Five Hundred Thousand U.S. Dollars (US\$13,500,000) (the "**Escrow Amount**") shall be deposited



with the Escrow Agent to be held in escrow to secure claims by Parent or Purchaser for indemnification claims pursuant to Section 13 and pursuant to the terms and conditions set forth in the Escrow Agreement (the “Escrow”). *Schedule 2.2(f)* sets forth the amount of Ordinary Shares and cash comprising the Escrow Amount on a per shareholder basis.

## 6. Representations and Warranties of Sellers.

As of the date of this Agreement, each Seller severally, and not jointly, represents and warrants to, and agrees with, Purchaser and Parent as follows:

6.1 *Organization, Authority and Qualification of Sellers.* Such Seller has all necessary power and authority to enter into this Agreement and the Ancillary Agreements to which he or it will become a party, to carry out his or its obligations hereunder and thereunder and to consummate the transactions contemplated hereby and thereby. This Agreement and the Ancillary Agreements to which such Seller will become a party have been or will be duly executed and delivered by such Seller, and (assuming due authorization, execution and delivery by Purchaser and Parent or such other parties thereto) this Agreement and the Ancillary Agreements, when executed and delivered, will constitute legal, valid and binding obligations of such Seller enforceable against such Seller in accordance with their terms. Such Seller has not taken any action to rescind its power-of-attorney agreement with the Sellers’ Representative.

6.2 *Ownership of the Purchased Shares.* *Schedule A* accurately and correctly sets out the Purchased Shares owned by such Seller. All of the Purchased Shares specified as owned by such Seller are free and clear of any Encumbrances and represent the entire interest of such Seller in the Company, and such Seller has no other interest in the Company, contingent or otherwise.

6.3 *No Conflict.* The execution, delivery and performance of this Agreement by such Seller does not and will not (a) violate, conflict with or result in the breach of any provision of the articles of incorporation (or similar organizational documents), if any, of such Seller; (b) assuming the receipt of all consents, approvals, waivers and authorizations and the making of the notices and filings set forth on *Schedule 6.4*, conflict with or violate (or cause an event which could have a Material Adverse Effect as a result of) any Law or Governmental Order applicable to such Seller; or (c) assuming the receipt of all consents, approvals, waivers and authorizations and the making of notices and filings set forth on *Schedule 6.4* or required to be made or obtained by Purchaser, Parent or the Company, conflict with, result in any breach of, constitute a default (or event which with the giving of notice or lapse of time, or both, would become a default) under, require any consent under, or give to others any rights of termination, amendment, acceleration, suspension, revocation or cancellation of, or result in the creation of any Encumbrance on such Purchased Shares as held by such Seller pursuant to, any note, bond, mortgage or indenture, contract, agreement, lease, sublease, license, sublicense, Permit, franchise or other instrument or arrangement to which such Seller is a party or by which any of the Purchased Shares is bound or affected, other than as set forth on *Schedule 6.3* and, in the case of clauses (ii) and (iii), conflicts, breaches, defaults, cancellations, accelerations, losses, violations or Encumbrances that would not, individually or in the aggregate, impair or delay such Seller’s ability to perform its obligations hereunder.

6.4 *Consents and Approvals.* Except as set forth on *Schedule 6.4*, the execution, the execution, delivery and performance of this Agreement, and the consummation of the transactions contemplated hereby, by such Seller do not and will not require any consent, approval or authorization of, filing with or notification to any Governmental Authority, creditor or other Person, other than, in the case of Section 6.3(b) and (c) above, conflicts, breaches, defaults, cancellations, accelerations, losses, violations or Encumbrances that would not, individually or in the aggregate, impair or delay such Sellers’ ability to perform its obligations hereunder.

6.5 *Brokers.* Except as set forth on *Schedule 6.5*, no broker or finder is entitled to any brokerage, finder’s or other fee or commission in connection with the transactions contemplated by this Agreement based upon arrangements made by or on behalf of such Seller.

6.6 *Residency.* Such Seller is not a U.S. Person, as such term is defined under Rule 902(k) of Regulation S, promulgated under the Securities Act.

## 7. Representations and Warranties of the Company.

Except as set forth in a correspondingly numbered schedule (the “**Disclosure Schedule**”) delivered to Purchaser and Parent dated as of the date of this Agreement, the Company represents and warrants to Purchaser that all representations and warranties contained in this Section 7 are true as of the date hereof and as of the Closing. On or prior to the Closing, the Company shall prepare and deliver an updated Disclosure Schedule reflecting any update or change that occurred or came into existence (or became known or material, as the case may be, where the applicable section is qualified by Knowledge, Material Adverse Effect or any other standard of materiality) after the date hereof. All references in the subsections of this Section 7 to “Company” shall include the Company’s subsidiaries except to the extent specifically excluded or except as otherwise clearly required by the context. The disclosures set forth in the Disclosure Schedule shall apply to all representations and warranties under this Agreement so long as such disclosures identifies by section number the section and subsection to which such disclosure relates (*provided, however*, that the Company shall be deemed to have adequately disclosed with respect to any section or subsection any matters that are clearly described elsewhere in such document if a reader(s) who has not been actively involved in the Company but is generally familiar with the Business can understand the applicability of such disclosure to such non-referenced sections or subsections). No update or change in the Disclosure Schedule will affect a determination of whether a breach of any representation or warranty in this Section 7 has occurred, which determination shall be made as if such update had not been delivered; *provided, however*, that updates and changes made with respect to contracts or other actions for which Purchaser has granted its written consent or any non-material update or change in the Disclosure Schedule which would not result in a Loss or Losses to Purchaser in excess of Fifty Thousand U.S Dollars (US\$50,000) individually or One Hundred Thousand U.S Dollars (US\$100,000) in the aggregate shall not be included in any determination of whether a breach of any representation or warranty in this Section 7 has occurred (and shall not be included in any calculation of Losses related to any indemnity amount or the Threshold under Section 13). The inclusion of any information in any section of the Disclosure Schedule or other documents made available or delivered by the Company pursuant to this Agreement shall be not be deemed to be an admission or evidence of the materiality of such item, nor shall it establish a standard of materiality for any purpose whatsoever. As of the date of this Agreement, the Company represents and warrants to, and agrees with, Purchaser and Parent as follows:

**7.1 Organization, Authority and Qualification of the Company.** The Company is a corporation duly organized and validly existing under the laws of Korea and has all necessary power and authority to own, operate or lease the Assets now owned, operated or leased by it and to carry on the Business as it has been and is currently conducted and to execute, deliver and perform this Agreement and the Ancillary Agreements to which it will become a party. Except as set forth on *Schedule 7.1*, all corporate actions taken by the Company have been duly authorized, and the Company has not taken any action that in any material respect conflicts with, constitutes a default under or results in a violation of any provision of its articles of incorporation (or similar organizational documents). A true and correct copy of the articles of incorporation (or similar organizational documents) of the Company, as in effect on the date hereof, has been delivered by the Company to Purchaser or Parent.

**7.2 Capital Stock of the Company.** *Schedule A* contains a true and accurate listing of all issued and outstanding shares of capital stock of the Company. Except as set forth on *Schedule 7.2*, the Purchased Shares and the Excluded Shares have been duly authorized, are validly issued, fully paid, and nonassessable, and constitute all of the issued and outstanding shares of capital stock of the Company. None of the Purchased Shares was issued in violation of any preemptive rights. *Schedule 2.2(d)* lists all of the outstanding Company Options that have been issued by the Company and not exercised as of the date hereof. Except for such options, there are no options, warrants, convertible securities or other rights, agreements, arrangements or commitments of any character relating to the capital stock of the Company or obligating Sellers or the Company to issue or sell any shares of capital stock of, or any other interest in, the Company. Except as set forth on *Schedule 7.2*, there are no outstanding contractual obligations of the Company to repurchase, redeem or otherwise acquire any of the Purchased Shares or to provide funds to, or make any investment (in the form of a loan, capital contribution or otherwise) in, any other Person.

7.3 *Subsidiaries.* Except as set forth on *Schedule 7.3*, the Company has no subsidiaries or branches and representative offices, proprietary interests or investments in securities, other than those held from time to time as short-term investments for the utilization of idle cash, and does not control, through stock ownership or otherwise, any corporation, partnership, joint venture, unincorporated association or other business entity.

7.4 *Corporate Books and Records.* The minute books of the Company contain accurate records of all meetings and accurately reflect all other corporate actions and decisions taken or subsequently ratified by the shareholders, board of directors of the Company in all material respects. Complete and accurate copies of all such minute books and of the stock register of the Company have been provided by the Company to Purchaser or Parent.

7.5 *No Conflict.* The execution, delivery and performance of this Agreement by the Company and Sellers does not and will not (a) violate, conflict with or result in the breach of any provision of the articles of incorporation (or similar organizational documents) of the Company; (b) assuming the receipt of all consents, approvals, waivers and authorizations and the making of the notices and filings set forth on *Schedule 7.6*, conflict with or violate (or cause an event which could have a Material Adverse Effect as a result of) any Law or Governmental Order applicable to the Assets, Business or the Company; or (c) assuming the receipt of all consents, approvals, waivers and authorizations and the making of notices and filings set forth on *Schedule 7.6* or required to be made or obtained by Purchaser, Seller or the Company, conflict with, result in any breach of, constitute a default (or event which with the giving of notice or lapse of time, or both, would become a default) under, require any consent under, or give to others any rights of termination, amendment, acceleration, suspension, revocation or cancellation of, or result in the creation of any Encumbrance on any of the Purchased Shares or on any of the Assets pursuant to, any note, bond, mortgage or indenture, contract, agreement, lease, sublease, license, sublicense, Permit, franchise or other instrument or arrangement to which the Company is a party or by which any of the Purchased Shares or any of such Assets is bound or affected other than, in the case of clauses (b) and (c) above, conflicts, breaches, defaults, cancellations, accelerations, losses, violations or Encumbrances that would not have, individually, or in the aggregate, a Material Adverse Effect.

7.6 *Consents and Approvals.* The execution, delivery and performance of this Agreement by the Company does not and will not require any consent, approval, permit, authorization, filing or notification to any Governmental Authority, creditor or other Person, except as set forth in *Schedule 7.6*, all of which shall be acquired or made, as the case may be, prior to the Closing Date.

7.7 *Financial Statements and Books and Records.*

(a) True and complete copies of the Audited Financial Statements and the Interim Financial Statements have been delivered by the Company to Purchaser and are attached hereto as *Schedule 7.7(a)*. The Audited Financial Statements and the Interim Financial Statements (i) were prepared in accordance with the books of account and other financial records of the Company; (ii) present fairly the financial condition and results of operations of the Company as of the respective dates thereof or for the respective periods covered thereby; (iii) have been prepared in accordance with Korean GAAP applied on a basis consistent with the past practices of the Company; and (iv) include all adjustments that are necessary for a fair presentation of the consolidated financial condition of the Company and the results of the operations of the Company as of the respective dates thereof or for the respective periods covered thereby; that the Interim Financial Statements are subject to normal year-end adjustments and the absence of notes.

(b) The books of account and other financial records of the Company (i) accurately reflect in all material respects items of income and expense and all Assets and Liabilities required to be reflected therein in accordance with Korean GAAP applied on a basis consistent with the past practices of the Company; (ii) are complete and correct in all material respects, and do not contain or reflect any material inaccuracies or discrepancies; and (iii) have been maintained in accordance with good accounting practices in all material respects.

(c) There has been no change in Company's accounting policies or the methods of making accounting estimates or changes in estimates that are material to the Financial Statements, other than as set forth in the Financial Statements. *Schedule 7.7(c)* lists, and the Company has delivered to Parent copies of the documentation creating or governing, all securitization transactions and "off-balance sheet arrangements" (as defined in Item 303(c) of Regulation S K promulgated by the SEC) effected by Company since December 31, 2006. Except as set forth in the Financial Statements, there are no liabilities, claims or obligations of any nature, whether accrued, absolute, contingent, anticipated or otherwise, whether due or to become due, that are required to be shown in the Financial Statements in accordance with Korean GAAP. Except as disclosed in the Financial Statements, Company is not a guarantor or indemnitor of any indebtedness of any other Person.

(d) Attached as *Schedule 7.7(d)* is the "**Projected Closing Balance Sheet**" for the Company based on an assumed Closing Date of April 26, 2007 and reasonable assumptions relating to the operation of the business conducted by the Company between the date of this Agreement and the Closing Date which shall be prepared on a basis consistent with the Audited and Interim Financial Statements, as adjusted pursuant to the Adjusted Korean GAAP.

*7.8 No Undisclosed Liabilities.* Except as set forth on *Schedule 7.8*, there are no Liabilities of the Company, other than the Liabilities reflected or reserved against on the Financial Statements and Liabilities that have arisen after the date of the Interim Financial Statements in the Ordinary Course of Business. Reserves are reflected on the Financial Statements against all Liabilities of the Company in amounts that have been established on a basis consistent with the past practices of the Company and in accordance with Korean GAAP applied consistently during the periods indicated. Other than as reflected on the Financial Statements, there are no contracts, agreements, transactions or obligations between Sellers and the Company. Except as set forth on *Schedule 7.8*, the Company has paid all dividends or other distributions, if any, that are or may become payable with respect to the shares of preferred stock of the Company for the periods preceding the Closing Date.

*7.9 Accounts Receivable.* Except to the extent, if any, reserved for on the Financial Statements or set forth on *Schedule 7.9*, all accounts receivable reflected on the Financial Statements and all accounts receivable existing on the Closing Date have arisen from the sale of goods or services in the Ordinary Course of Business and, except for those accounts receivable that have been collected, constitute only valid, undisputed claims of the Company which are not subject to valid claims of set-off or other defenses or counterclaims other than normal cash discounts accrued or returns in the Ordinary Course of Business. Except as set forth on *Schedule 7.9*, all accounts receivable reflected on the Financial Statements or arising from the date thereof until the Closing (subject to the reserve for bad debts, if any, reflected on the Financial Statements), unless already collected, are or will be as of the Closing Date good and collectible, without resort to litigation or extraordinary collection activity, within ninety (90) days after the Closing Date.

*7.10 Permits.* *Schedule 7.10* describes all material Permits from Governmental Authorities necessary to conduct the Business, all of which have been secured and are valid and in full force and effect and there is no Action which would or is reasonably likely to, result in the suspension, cancellation, modification or revocations of any of its Permits. None of such Permits shall be invalidated or become voidable as a result of the consummation of the transactions contemplated hereby. No consent, approval or notice is necessary in connection with the consummation of the transactions contemplated hereby in order to maintain in full force and effect all of such Permits. The Company is in material compliance with the terms and conditions of all such Permits. Except as specified on *Schedule 7.10*, all such Permits are renewable in the Ordinary Course of Business.

*7.11 Conduct in the Ordinary Course of Business; Absence of Certain Changes, Events and Conditions.* Since February 28, 2007, the Business has been conducted in the Ordinary Course of Business. As amplification and not limitation of the foregoing, since February 28, 2007, except as disclosed on *Schedule 7.11*:

- (a) the Company has not been served notice of any failure to pay any creditor any amount owed to such creditor when due;

(b) the Company has not redeemed any of the capital stock or declared, made or paid any dividends or distributions (whether in cash, securities or other property) to the holders of capital stock of the Company or otherwise;

(c) the Company has not issued or sold any capital stock, notes, bonds or other securities of the Company, or any option, warrant or other right to acquire the same, or any other interest in the Company;

(d) the Company has not failed to maintain the Assets in accordance with good business practice and in good operating condition and repair;

(e) the Company has not incurred, or guaranteed, any Indebtedness in excess of Twenty Million Korean Won (KRW20,000,000) individually or Sixty Million Korean Won (KRW60,000,000) in the aggregate;

(f) the Company has not suffered any Material Adverse Effect;

(g) the Company has not agreed, whether in writing or otherwise, to take any of the actions specified in this Section 7.11 or make any commitment with respect to any of the actions specified in this Section 7.11, except as expressly contemplated by this Agreement;

(h) the Company has not made any increase in the compensation or benefits payable or to become payable to any employee of the Company;

(i) the Company has not made any sale, transfer or disposal or purchase of properties or assets with a value in excess of Twenty Million Korean Won (KRW20,000,000) other than in the Ordinary Course of Business; or

(j) the Company has not made any payment or distribution of any funds or assets of the Company to any Seller or any other affiliate other than payments for goods and services (including employment) by the Company to Seller or an affiliate based on arms-length transactions.

*7.12 Customers, Distributors and Suppliers.* *Schedule 7.12* contains a true and complete list of all customers, distributors, representatives and agents of the Company and a description of their respective relationships with the Company. *Schedule 7.12* contains a true and complete list of all Persons who provided goods or services to the Company in the twelve (12) month period ended as of the date of this Agreement to which the Company paid or is committed to pay Fifteen Million Korean Won (KRW15,000,000) (or its equivalent in another currency) or more since the beginning of such period. The Company's relations with the foregoing Persons are good and, except as described in *Schedule 7.12*, there are no disputes between the Company and any of such Persons pending or, to the best Knowledge of the Company, threatened. All contracts with the foregoing Persons are in full force and effect in accordance with their terms, and there are no defaults or assertions of default thereunder. Since January 1, 2007, the Company has not received any notice from any customer, supplier or distributor that such customer, supplier or distributor, as the case may be, intends to discontinue or substantially curtail purchasing from, selling to or distributing for the Company's Business.

*7.13 Related Party Transactions.* Except as set forth in *Schedule 7.13* or as contemplated by this Agreement, no employee, officer, shareholder, partner, or director of any Seller or the Company has any interest in any of the Assets or is a party to any agreement, commitment or lease with the Company or affecting the Business or the Assets.

*7.14 Litigation.* Except as set forth in *Schedule 7.14*, there are no Actions by or against the Company (or by or against Sellers and relating to the Business or the Company), or affecting any of the Assets, pending before any Governmental Authority (or, to the Knowledge of the Company, threatened to be brought by or before any Governmental Authority). Neither the Company nor the Assets are subject to any Governmental Order (or, to the

Knowledge of the Company, are there any such Governmental Orders threatened to be imposed by any Governmental Authority) which has or has had a Material Adverse Effect.

7.15 *Compliance with Laws.* The Company has conducted the Business, in all material respects, in accordance with all Laws and Governmental Orders applicable to the Company, use of any of the Assets or conduct of the Business, and the Company is not in violation of any such Law or Governmental Order which, other than any breach, noncompliance, violation or failure of the following which, individually or in the aggregate would not result in a Material Adverse Effect. The Company has not received notice of any violation of any Laws or Governmental Orders which has not been cured.

7.16 *Material Contracts.*

(a) *Schedule 7.16(a)* lists the following Material Contracts:

(i) each contract and agreement for the purchase or sale of technologies, materials or personal property with any supplier or for the furnishing of services to the Company, or otherwise related to the Business under the terms of which the Company: (A) is likely to pay or otherwise give consideration of more than Twenty Million Korean Won (KRW20,000,000) in the aggregate during the calendar year ended December 31, 2006; (B) is likely to pay or otherwise give consideration of more than Fifty Million Korean Won (KRW50,000,000) in the aggregate over the remaining term of such contract; (C) cannot cancel such contract or agreement without penalty or further payment of more than Twenty Million Korean Won (KRW20,000,000) and without more than thirty (30) days' notice; or (D) resulting in payment to and from the Company of more than Twenty Million Korean Won (KRW20,000,000) during the calendar year ended December 31, 2006;

(ii) all franchise, broker, distributor, dealer, manufacturer's representative, agency, sales promotion, market research, marketing consulting and advertising contracts and agreements to which the Company is a party;

(iii) all management contracts and contracts with independent contractors or consultants (or similar arrangements) to which the Company is a party and which are not cancelable without penalty or further payment and without more than thirty (30) days' notice;

(iv) all contracts and agreements relating to Indebtedness of the Company;

(v) all contracts and agreements with any Governmental Authority to which the Company is a party and such Governmental Authority is a direct party;

(vi) all contracts and agreements that limit or purport to limit the ability of the Company to compete in any line of business or with any Person or in any geographic area or during any period of time;

(vii) all contracts and agreements between or among the Company and Sellers or any of Sellers' affiliates;

(viii) all contracts and agreements providing for benefits under any Employee Plan;

(ix) all leases and subleases pertaining to each parcel of the Leased Real Property, including (A) the street address of each parcel of Leased Real Property, (B) the identity of the lessor, lessee and current occupant (if different from lessee) of each such parcel of Leased Real Property, (C) the term (referencing applicable renewal periods) and rental payment terms of the leases (and any subleases) pertaining to each such parcel of Leased Real Property, and (D) the current use of each such parcel of Leased Real Property; and

(x) all other contracts and agreements whether or not made in the Ordinary Course of Business, which are material to the Company, or the conduct of the Business or the absence of which would have a Material Adverse Effect.

(b) Each Material Contract is valid and binding on the respective parties thereto and is in full force and effect, and the consummation of the transactions contemplated by this Agreement does not and will not result in any Material Contract not being valid, binding, or in full force or effect. The Company is not in breach of, or default under, any Material Contract, except for such breaches or defaults that would not individually or in the aggregate have a Material Adverse Effect.

(c) To the Knowledge of the Company, no other party to any Material Contract is in material breach thereof or material default thereunder.

(d) There is no contract, agreement or other arrangement granting any Person any preferential right to purchase any of the Assets, other than in the Ordinary Course of Business.

#### *7.17 Intellectual Property.*

(a) *Schedule 7.17(a)* sets forth (i) a true, correct and complete list and a brief description of all Owned Intellectual Property that are registered with or filed for registration with any Governmental Authority, including a complete identification of each patent and patent application; and (ii) a true, correct and complete list and a brief description of all Licensed Intellectual Property, other than any software that is generally available on standard terms for less than Ten Thousand U.S. Dollars (US\$10,000) per copy, seat, CPU or named user. The rights of the Company in or to such Owned Intellectual Property and Licensed Intellectual Property do not conflict with or infringe on the rights of any other Person, and neither Sellers nor the Company has received any claim or written notice from any Person to such effect.

(b) The Company has delivered to Purchaser true, correct and complete copies of the registrations for Owned Intellectual Property and agreements pursuant to which the Licensed Intellectual Property identified on *Schedule 7.17(a)* have been licensed or sublicensed to the Company.

(c) The Company owns all Owned Intellectual Property free and clear of any Encumbrance, other than any non-exclusive licenses granted by the Company in the ordinary course of business. The Company has the right, pursuant to valid and enforceable licenses, to use the Licensed Intellectual Property in the manner in which the Licensed Intellectual Property is currently being used. No Actions have been made or asserted or are pending (and, to the Knowledge of the Company, no Action has been threatened) against the Company either (i) based upon or challenging or seeking to deny or restrict the use by the Company of any of the Owned Intellectual Property or the Licensed Intellectual Property; or (ii) alleging that any Owned Intellectual Property or Licensed Intellectual Property is being licensed, sublicensed or used in violation of patents, copyrights or trademarks or any other rights of any Person. To the Knowledge of the Company, no Person is using any patents, copyrights, trademarks, service marks, trade names, trade secrets or similar property that are confusingly similar to the Owned Intellectual Property or the Licensed Intellectual Property that is exclusively licensed to the Company or that infringe upon the Owned Intellectual Property or the Licensed Intellectual Property that is exclusively licensed to the Company or upon the rights of the Company. The consummation of the transactions contemplated by this Agreement will not result in the termination or impairment of any of the Owned Intellectual Property or Licensed Intellectual Property or any of the rights of the Company in any of the Owned Intellectual Property or Licensed Intellectual Property.

(d) Each of the Company's pending applications relating to trademarks, service marks, copyrights and patents have been made and filed by the Company in good faith.

(e) To the Knowledge of the Company, no product, service or business activity of the Company infringes or has infringed or otherwise violates or has violated the intellectual property rights of any other Person, and no Actions have been made or asserted or are pending (and, to the Knowledge of the Company, no Action has been threatened) against the Company alleging that any product, service or business activity of the Company infringes or violates the intellectual property rights of any other Person.

**7.18 Real Property.** The Company does not own any Real Property. The Company does not lease any Real Property except as specified on *Schedule 7.18*. The Company has valid and outstanding leasehold interests in all Real Property that it leases from others and the improvements situated thereon, all of which are listed and identified on *Schedule 7.18*. The Company's use and occupation of such Real Property and the improvements thereon comply in all material respects with the applicable Law, including zoning regulations and building codes.

**7.19 Tangible Personal Property.** *Schedule 7.19* lists each item of tangible personal property with a value (as determined in accordance with Korean GAAP) over Five Million Korean Won (KRW5,000,000) (the "**Tangible Personal Property**") used in the Business or owned or leased by the Company. The Company has good and marketable title, or valid and effective leasehold rights in the case of leased property, to all Tangible Personal Property, free and clear of all Encumbrances except as specifically listed on *Schedule 7.19*. The Tangible Personal Property is in good repair and operating condition, normal wear and tear and required maintenance (which has heretofore been regularly performed) excepted.

**7.20 Inventories.** The inventories of the Company reflected on the Audited Financial Statements and on the Interim Financial Statements are stated at not more than the lower of cost or net realizable value, on a gross-average basis, with adjustments for obsolete or otherwise not readily marketable items. All of the inventories of the Company are usable or saleable in the Ordinary Course of Business and are fit for the purpose for which they were intended except as set forth in the Financial Statements except for obsolete items and items of below-standard quality, all of which have been written-off or written-down to net realizable value on the Audited Financial Statements and on the Interim Financial Statements.

#### **7.21 Assets.**

(a) The Company owns, leases or has the legal right to use all the properties and assets, including without limitation the Leased Real Property, used or intended to be used in the conduct of the Business or otherwise owned, leased or used by the Company and, with respect to contract rights, is a party to and enjoys the right to the benefits of all contracts, agreements and other arrangements used or intended to be used by the Company or in or relating to the conduct of the Business (all such properties, assets and contract rights being the "**Assets**"). The Company has good and marketable title to, or, in the case of leased or subleased Assets, valid and subsisting leasehold interests in, all the Assets, free and clear of all Encumbrances, except as disclosed on *Schedule 7.21(a)*.

(b) The Assets constitute all the properties, assets and rights forming a part of, used, held or intended to be used in the Business. At all times since the date of the Interim Financial Statements, the Company has caused the Assets to be maintained in accordance with good business practice, and all the Assets are in good operating condition and repair and are suitable for the continued conduct of the Business, subject to normal wear and tear.

(c) The consummation of the transactions contemplated by this Agreement will not result in the incurrence of any penalty or other adverse consequence with respect to the Company's respective interest in the Assets or the ownership or possession of any documents, books, records, agreements and financial data of any sort used by the Company in the conduct of the Business.

**7.22 Employee Benefit Matters.** *Schedule 7.22* lists sets forth all Employee Plans. No event has occurred and there exists no condition or set of circumstances in connection with which the Company could be subject to any



material Liability under the terms of such Employee Plans or under the Law, except those Liabilities that have accrued in the Ordinary Course of Business but are not due pursuant to the terms of any Employee Plan. Except as contemplated in this Agreement or any Ancillary Agreement, neither the execution and delivery of this Agreement nor the consummation of the transactions contemplated hereby, either alone or together with a series of related events, will (i) result in any material payment (including without limitation severance, unemployment compensation or otherwise) becoming due under any Employee Plan; (ii) increase the benefits otherwise payable under any Employee Plan; (iii) result in the acceleration of the time of payment, vesting or funding of any material benefits under any Employee Plan; or (iv) affect in any material respect any Employee Plan's current treatment under any Laws.

*7.23 Labor Matters.* The Company is not a party to any collective bargaining agreement or other labor union contract applicable to persons employed by the Company, and currently there are no organizational campaigns, petitions or other unionization activities seeking recognition of a collective bargaining unit which could materially affect the Company. There are no controversies, strikes, slowdowns, lock-outs or work stoppages pending or, to the Knowledge of the Company, threatened between the Company and any of the employees, and the Company has not experienced any such controversy, strike, slowdown, lock-outs or work stoppage within the past three years. Except as set forth on *Schedule 7.23*, the Company is currently in compliance in all material respects with all applicable Laws relating to the employment of labor, including without limitation those related to wages, hours and collective bargaining, and is not liable for any arrears of wages, taxes, allowances, benefits, severance pay, penalties or other sums for failure to comply with any of the foregoing. Except as set forth on *Schedule 7.23*, the Company has paid in full to all current and former directors, officers and employees or adequately accrued for in accordance with Korean GAAP all wages, salaries, commissions, bonuses, benefits allowances, severance pay and other compensation due to or on behalf of the current and former directors, officers and employees. The Company is not a party to, or otherwise bound by, any consent decree with, or citation by, any Governmental Authority relating to employees or employment practices. There are no Actions that have been asserted or is now pending or, to the Knowledge of the Company, threatened with respect to the Company for unfair labor practices, payment of withholding taxes, payment of wages, salary or severance, safety and health standards or discrimination in employment practices. The Company has made all required contributions, concerning national pension, national medical insurance, worker's compensation insurance, unemployment insurance and other mandatory social security matters.

*7.24 Taxes.* Since January 1, 2002, all returns and reports in respect of Taxes required to be filed with respect to the Company have been timely filed. All Taxes required to be shown on such returns and reports or otherwise due have been timely paid. All such returns and reports are true, correct and complete in all material respects. No adjustment relating to such returns has been proposed formally or informally by any Tax Authority and the Company is not (i) a party to any agreement, arrangement or election with any Tax Authority and (ii) liable for Taxes in relation to transfer pricing. There are no pending or, to the Knowledge of the Company, threatened Actions for the assessment or collection of Taxes against the Company. The Company is not subject to any material additional unpaid Tax investigation and, to the Knowledge of Sellers, no notices of any dispute regarding material Tax receivable from the Company have been received by the Company. There are no tax liens on any Assets other than for Taxes not yet due. No power of attorney that is currently in force has been granted with respect to any matter relating to Taxes that could affect the Company. On the Financial Statements, reserves and allowances have been provided adequate to satisfy all Liabilities for Taxes relating to the Company as of the date thereof (without regard to the materiality thereof).

*7.25 Insurance.* The Company maintains insurance policies consistent with customary practices and standards of companies engaged in businesses and operations similar to those of the Company. A list of such insurance policies (including the policy number, the amount of coverage, the type of insurance, insurance carrier, annual premium, date of expiration, and any pending claims or contributions thereunder which are material to Sellers) is contained on *Schedule 7.25*.

## 7.26 Environment.

(a) The Company has not engaged in or permitted any operations or activities upon, or any use or occupancy of, any parcel of the Real Property (or any portion thereof) for the purpose of or in any way involving the handling, manufacture, treatment, storage, use, generation, release, discharge, refining, dumping or disposal of any Hazardous Materials on, under, in or about any parcel of the Real Property, or transported any Hazardous Materials to, from or across any parcel of the Real Property.

(b) The Company is in compliance with, and there are no existing violations by the Company under, all applicable Environmental Laws in all material respects, and no investment or expense is required by the Company in order to maintain such compliance.

(c) The Company has obtained all Permits and filed all notices which are required to be obtained or filed by it or those engaged by it for use of the Assets and the conduct of the Business under applicable Environmental Laws, and there has been no change in the facts and circumstances reported or assumed in the application for or granting of such Permits.

(d) The Company is in compliance in all material respects with all terms and conditions of such required Permits, including without limitation filing all notices, reports and other statements which are required to be obtained or filed under such Permits.

*7.27 Product Liability and Product Warranty.* Schedule 7.27 contains a true and complete description of (i) all warranties granted or made with respect to products sold, or services rendered, by the Company; and (ii) the Company's product liability and product warranty experience for the last three (3) years. Except as set forth in Schedule 7.27, the Company has not suffered any product liability or product warranty claims. To the Knowledge of the Company, the Company has not distributed, supplied or sold products which are or alleged to be faulty, defective or which do not comply with any representations or warranties expressly or impliedly made by the Company. The Company has or has had, during the last three years before the Closing Date, no liability, whether based on strict liability, negligence, breach of warranty (express or implied), breach of contract or otherwise, in respect of any product, component or other item manufactured, sold, designed or produced prior to the Closing, or services rendered prior to the Closing.

*7.28 Loan Agreements.* Details (including the amount of principal and interest outstanding) of all financial or credit facilities which on the Closing will remain outstanding or available to the Company are set forth on Schedule 7.28 and there are no circumstances other than the transactions contemplated by this Agreement or the cancellation of any guarantee by the current present guarantor thereunder, whereby the continuation of any such financial or credit facilities might cease or be prejudiced, or which may give rise to any alteration in the terms and conditions of any of the such financial or credit facilities.

*7.29 Brokers.* Other than payments disclosed on Schedule 7.29, No broker or finder is entitled to any brokerage, finder's or other fee or commission in connection with the transactions contemplated by this Agreement based upon arrangements made by or on behalf of the Company.

*7.30 Full Disclosure.* To the Knowledge of the Company, no representation or warranty or other statement made with respect to the Company in this Agreement (including those in the Disclosure Schedule), the Financial Statements or any certificate delivered pursuant to the transactions contemplated by this Agreement contains any untrue statement of a material fact or omits to state a material fact necessary to make such representation or warranty or other statement, in light of the circumstances in which it was made, not misleading.

*7.31 No Other Representations or Warranties.* Except for the representations and warranties contained in this Section 7, the Company makes no other express or implied representation or warranty on behalf of the Company.

## 8. Representations and Warranties of Purchaser and Parent.

As of the date of this Agreement, Purchaser and Parent represent and warrant to, and agree with, Sellers and the Company as follows:

8.1 *Organization.* Purchaser is a corporation duly organized, validly existing and in good standing under the laws of the Cayman Islands, with full power and authority to conduct its business in the manner in which it has been conducted and to execute, deliver and perform this Agreement and the Ancillary Agreements to which it will become a party. Parent is a corporation duly organized, validly existing and in good standing under the laws of the Cayman Islands, with full power and authority to conduct its business in the manner in which it has been conducted and to execute, deliver and perform this Agreement and the Ancillary Agreements to which it will become a party. Purchaser and Parent are duly qualified to do business in, and are in good standing under the laws of, each jurisdiction in which the property owned or leased by them or the nature of their businesses requires such qualification, except where the lack of such qualification would not have a material adverse effect on the business, assets or liabilities of Purchaser or Parent.

8.2 *Authority.* The execution, delivery and performance of this Agreement and the Ancillary Agreements by Purchaser and Parent have been duly authorized by all necessary corporate action. This Agreement and each Ancillary Agreement, when executed and delivered by Purchaser and Parent, shall be legal, valid and binding obligations of Purchaser and/or Parent, enforceable against it or them, as the case may be, in accordance with the terms hereof and thereof.

### 8.3 Capitalization and Ordinary Shares.

(a) The authorized share capital of Parent consists Five Hundred Million (500,000,000) shares, of which 124,599,020 have been designated and issued as Ordinary Shares as of March 31, 2007. Since March 31, 2007, Parent has not issued any shares of its capital stock, other than options of Parent and the Ordinary Shares issued pursuant to exercise of such options. As of the date hereof, Twenty Five Million (25,000,000) Ordinary Shares are reserved for issuance upon the exercise of outstanding options under the Parent Plan and options for Fifteen Million and Twenty Thousand (15,020,000) Company Common Shares have been granted and Nine Million, Nine Hundred and Eighty Thousand (9,980,000) remain outstanding. As of the date hereof, Parent has no shares of preferred stock either designated or outstanding. All of the outstanding shares of the capital stock of Parent have been duly authorized and validly issued, and are fully paid and non-assessable. Except as set forth on *Schedule 8.3*, there are no other preemptive or outstanding rights, options, warrants, conversion rights, stock appreciation rights, redemption rights, repurchase rights, agreements, arrangements or commitments of any character under which Parent is or may become obligated to issue or sell any shares of capital stock or other equity interests, or any securities or obligations exercisable or exchangeable for or convertible into any shares of capital stock or other equity interests, of Parent, and no securities or obligations evidencing such rights are authorized, issued or outstanding. Other than the Company's Deposit Agreement with the Bank of New York relating to its ADSs, the outstanding shares of capital stock and other equity interests of Parent are not subject to any voting trust arrangement or other contract, agreement or arrangement restricting or otherwise relating to the voting, dividend rights or disposition of such stock or other equity interests. There are no phantom stock or similar rights providing economic benefits based, directly or indirectly, on the value or price of such stock or other equity interests of Parent.

(b) Prior to the Closing, Parent will have taken all necessary action to permit it to issue or otherwise deliver the Ordinary Shares to be delivered in connection with the transactions contemplated hereby. The Ordinary Shares, when issued and delivered by Parent as described herein, will be duly authorized, validly issued, fully paid, nonassessable and free and clear of any and all Encumbrances and in suitable form for transfer to the Ordinary Share Recipients, and no Person will have any preemptive right of subscription or purchase or any other right in respect thereof.

8.4 *No Conflict.* The execution, delivery and performance of this Agreement by Purchaser or Parent does not and will not (a) violate, conflict with or result in the breach of any provision of the articles of incorporation (or

similar organizational documents), if any, of Purchaser or Parent; (b) conflict with or violate (or cause an event which could have a Material Adverse Effect as a result of) any Law or Governmental Order applicable to Purchaser or Parent; or (c) conflict with, result in any breach of, constitute a default (or event which with the giving of notice or lapse of time, or both, would become a default) under, require any consent under, or give to others any rights of termination, amendment, acceleration, suspension, revocation or cancellation of, or result in the creation of any Encumbrance on any of the Ordinary Shares pursuant to, any note, bond, mortgage or indenture, contract, agreement, lease, sublease, license, sublicense, Permit, franchise or other instrument or arrangement to which such Seller is a party or by which any of the Purchased Shares is bound or affected, other than, in the case of clauses (b) and (c), conflicts, breaches, defaults, cancellations, accelerations, losses, violations or Encumbrances that would not, individually or in the aggregate, impair or delay Purchaser's or Parent's ability to perform its obligations hereunder.

8.5 *Consents and Approvals.* No consent, approval, waiver, authorization, notice or filing is required to be obtained by Purchaser or Parent from, or to be given by Purchaser or Parent to, or made by Purchaser or Parent with, any Governmental Authority, except as set forth on *Schedule 8.5*.

8.6 *Brokers.* Other than Needham & Company, LLC, no broker or finder is entitled to any brokerage, finder's or other fee or commission in connection with the transactions contemplated by this Agreement based upon arrangements made by or on behalf of Purchaser or Parent.

8.7 *Investigation and Evaluation.* Purchaser and Parent acknowledge that (a) they are experienced in the operation of the type of business conducted by the Company, and (b) they and their directors, officers, attorneys, accountants and advisors have been given a full opportunity to examine the books, records and other information with respect to the Company and ask questions of the Company.

8.8 *SEC Filings; Financial Statements.*

(a) Parent has timely filed, in all material respects, all forms, reports, schedules, statements and other documents required to be filed by it during the twelve (12) months immediately preceding the date of this Agreement (collectively, as supplemented and amended since the time of filing, and including any such reports filed subsequent to the date hereof, the "**Parent SEC Reports**") with the SEC. The Parent SEC Reports (i) were prepared in all material respects in accordance with all applicable requirements of the Securities Act and the Exchange Act, as applicable, and (ii) did not, and will not (with respect to the Parent SEC Reports filed after the date hereof), contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary in order to make the statements therein, in light of the circumstances under which they were made, not misleading. The representation in clause (ii) of the preceding sentence does not apply to any misstatement or omission in any Parent SEC Report that was superseded by subsequent Parent SEC Reports.

(b) The audited consolidated financial statements and unaudited consolidated interim financial statements of Parent and its consolidated subsidiaries included or incorporated by reference in the Parent SEC Reports have been prepared in accordance with U.S. GAAP consistently applied during the periods indicated (except as may otherwise be indicated in the notes) and present fairly the financial position, results of operations and cash flows of Parent and its consolidated subsidiaries on a consolidated basis at the respective dates and for the respective periods indicated (except interim financial statements may not contain all notes and are subject to year-end adjustments).

8.9 *Litigation.* There are no Actions by or against Parent or Purchaser, or affecting their respective assets, pending before any Governmental Authority (or threatened in writing to be brought by or before any Governmental Authority), which, individually or in the aggregate, would impair or delay the ability of Parent or Purchaser to effect the Closing. Neither Parent nor Purchaser is subject to any Governmental Order or award, injunction or decree of any arbitrator or arbitrators that, individually or in the aggregate, would impair or delay the ability of Parent or Purchaser to effect the Closing.

8.10 *Books and Records*. Each of Purchaser and Parent maintains complete and accurate books of accounts and records reflecting in accordance with U.S. GAAP all material items of income and expenses, all material transactions and all material assets and liabilities required to be reflected therein in accordance with applicable Law and U.S. GAAP and maintained in accordance with sound business practices and a system of internal accounting controls sufficient to provide reasonable assurances that (i) transactions are executed in accordance with management's general or specific authorization, (ii) transactions are recorded as necessary to permit preparation of the consolidated financial statements of Purchaser or Parent, as the case may be, and its subsidiaries in accordance with U.S. GAAP and to maintain asset accountability, and (iii) assets are reconciled at reasonable intervals and appropriate action is taken with respect to any material differences.

8.11 *Undisclosed Liabilities*. Neither Purchaser nor Parent has any material liability of any nature, whether accrued, absolute, or contingent, other than (a) liabilities that are properly and accurately reflected (or adequately reserved against) on their consolidated balance sheets, (b) liabilities incurred in the Ordinary Course since December 31, 2006, or (c) liabilities incurred in the Ordinary Course that are not required to be reflected in the balance sheets under U.S. GAAP.

8.12 *Absence of Changes*. Since December 31, 2006, there has not been any material change in the financial condition, properties, assets, liabilities, business or operations of Purchaser or Parent which change by itself or in conjunction with all other such changes, whether or not arising in the Ordinary Course, has had or will have a material adverse effect thereon.

8.13 *Availability of Funds*. Purchaser has available, and will have available on the Closing Date, sufficient funds to enable Purchaser to consummate the Transaction and to pay all of the Cash Consideration plus, as applicable, the Earn-Out. No action or proceeding has been commenced by or against Purchaser under any bankruptcy Law of any relevant jurisdiction for the relief of debtors or for the enforcement of the rights of creditors.

8.14 *No Other Representations or Warranties*. Except for the representations and warranties contained in this Section 8, Parent and Purchaser are making no other express or implied representation or warranty on behalf of the Company.

#### 9. *Covenants of Sellers and the Company*.

9.1 *Conduct of Business*. Between the date hereof and the Closing Date, unless otherwise set forth on Schedule 9.1 or agreed in advance in writing by Parent or Purchaser, the Company shall:

- (a) conduct the Business only in the usual and Ordinary Course of Business;
- (b) refrain from amending the articles of incorporation of the Company or its internal rules or regulations;
- (c) refrain from making any material change in its accounting practices or procedures other than changes required by Korean GAAP;
- (d) except as required by Law, not take any action that would render, or which reasonably may be expected to render, any representation or warranty made by the Company in this Agreement untrue at the Closing;
- (e) refrain from (i) making any purchases, sales or transfers of any material properties; (ii) entering into any Material Contracts; (iii) mortgaging, pledging, subjecting to lien or otherwise encumbering any of its material Assets; and (iv) borrowing or lending any funds outside of the Ordinary Course of Business or in an amount less than Twenty Million Korean Won (KRW20,000,000);

(f) refrain from incurring any Liabilities other than those that are in the Ordinary Course of Business or in an amount less than Twenty Million Korean Won (KRW20,000,000);

(g) except as required by Law, refrain from making any change in the compensation or benefit payable or to become payable to any of its employees or agents or making any new bonus payment or arrangement or benefit to or with any of them;

(h) have in effect and maintain at all times all insurance now in force as described in *Schedule 7.25*;

(i) except as contemplated by this Agreement, refrain from changing the number of authorized or issued shares of its capital stock, from declaring, setting aside or paying any dividend or other distribution with respect to the capital stock, or from directly or indirectly redeeming, purchasing or otherwise acquiring any additional shares of its capital stock or effecting a split, reclassification or other change in or of any of its capital stock; and

(j) use commercially reasonable efforts to preserve the Business organization intact, to keep available the services of its present officers and employees and to make no changes therein, and to preserve the goodwill of all suppliers, customers, sales representatives and others having business relations with the Company.

9.2 *Access*. From the date of this Agreement through the Closing Date, the Company shall allow Purchaser's representatives, attorneys and accountants reasonable access during normal business hours upon reasonable notice to the records and files, audits and properties of the Company as well as all information relating to taxes, commitments, contracts, titles and financial condition of, or otherwise pertaining to, the business and affairs of the Company. From the date hereof, the Company will use commercially reasonable efforts to cause its accountants to cooperate with Purchaser and its accountants in making available all financial information concerning the Company as is requested, and Purchaser and its accountants shall have the right to examine all working papers pertaining to examinations of the Company, or preparation of its reports, by its accountants, *provided, however*, that in no event shall Purchaser have access to any information that (i) based on advice of Sellers' counsel, would create any potential Liability under applicable Laws or (ii) in the reasonable judgment of Sellers, would (A) result in the disclosure of any trade secrets of third parties or (B) violate any obligation of Seller or the Company with respect to confidentiality; provided, further, that in connection with (ii) above, if such information in question is set forth in a Material Contract, the Company shall provide Purchaser with a summary of the material terms of such Material Contract, together with such additional information reasonably requested by Parent to satisfy its due diligence investigations, but in recognition of the confidential nature of such agreement. All requests for information made pursuant to this Section 9.2 shall be directed to Insoo Kim or such Person or Persons as may be designated by the Sellers' Representative. All information received pursuant to this Section 9.2 shall be governed by Section 17.16 and the Non-Disclosure Agreement.

9.3 *Authorizations*. The Company shall use commercially reasonable efforts to obtain all Permits, if any, necessary to allow the consummation by Sellers of the transactions contemplated hereby.

9.4 *Conditions*. Sellers and the Company will use their commercially reasonable efforts to cause the conditions set forth in Section 11 to be satisfied and to consummate the transactions contemplated by this Agreement as soon as reasonably possible and in any event prior to the Closing Date.

9.5 *No Shop*. Between the date of this Agreement and the Closing Date, or unless earlier terminated in accordance with this Agreement, none of the Sellers' Representative, the Company or any of their respective officers, directors, affiliates, employees, representatives or agents, shall, directly or indirectly, solicit, initiate or participate in any way in discussions or negotiations with, or provide any information or assistance to, any Person or group of Persons (other than Purchaser) concerning any sale or other disposition of the Purchased Shares, Business or the Assets (other than sales of inventory in the Ordinary Course of Business) or assist or

participate in, facilitate or encourage any effort or attempt by any other Person to do or seek any of the foregoing. Sellers and the Company shall promptly communicate to Purchaser in writing the terms of any proposal or contract which it or the Company may receive in respect of any such transaction.

#### 10. *Covenants of Purchaser and Parent.*

10.1 *Conditions.* Purchaser and Parent will use their commercially reasonable efforts to cause the conditions set forth in Section 12 to be satisfied and to consummate the transactions contemplated by this Agreement as soon as reasonably possible and in any event prior to the Closing Date.

10.2 *Foreign Investment Report.* Prior to the Closing, Purchaser shall prepare and submit to the applicable Korean government authorities a report of foreign investment under the Foreign Investment Promotion Law and other related documents with respect to the purchase of the Purchased Shares, and Sellers and the Company shall render commercially reasonable assistance and support to Purchaser in such preparation and submission.

10.3 *Authorizations.* Each of Purchaser and Parent shall use commercially reasonable efforts to obtain all Permits, if any, necessary to allow the consummation by Purchaser or Parent, respectively, of the transactions contemplated hereby.

10.4 *Employees; Contingent Grants.* Each of the officers and employees of the Company will continue as an officer or employee, as the case may be, after the Closing Date, on substantially the same terms and conditions as he or she was employed immediately prior to the Closing Date. Each officer and employee will receive total compensation and benefits no less than the total compensation and benefits, including such benefits receivable under the Employee Plans, (or in the case of commissioned employees, not less than the commission structure) provided to such employee or officer by the Company immediately prior to the Closing Date. *Schedule 10.4* sets forth those anticipated grants of new restricted stock units under the Parent Plan immediately following the Closing to those certain employees of the Company, in the amounts set forth on *Schedule 10.4* and in the form of the restricted stock unit agreement set forth as *Exhibit 10.4*, which shall result in an expense to Parent of no less than Three Million U.S. Dollars (US\$3,000,000); *provided* that if the Continuous Service, as such term is defined under the Parent Plan, of any of the recipients of such restricted stock units ends prior to the full vesting of his/her portion of such restricted stock units and such restricted stock units are not vested as a result of such termination of service pursuant to the applicable restricted stock unit agreement, the unvested portion of his/her restricted stock units shall be repurchased pursuant to Section 7(b)(v) of the Parent Plan and Parent shall grant such officers or employees of the Company as designated by Kwang Jun Yun, with consultation and final approval from the President and the Board of Directors or Compensation Committee of Parent, the same number of new restricted stock units that were cancelled under the Parent Plan pursuant to such termination of Continuous Service.

10.5 *Listing of Additional Shares.* Prior to the Closing Date, if required by the rules of the Nasdaq Global Market, Silicon Motion shall file with the Nasdaq Global Market a Notification Form for Listing of Additional Shares with respect to the Ordinary Shares and Parent's American Depositary Shares representing all of the Stock Consideration, and shall ensure that the ADS program with the Bank of New York provides for sufficient number of American Depositary Shares of Parent to account for the Ordinary Shares representing all of the Stock Consideration, in addition to the number of American Depositary Shares of Parent representing all of Parent's ordinary shares issued and outstanding at such time. At any time after the Closing, Parent shall bear all of the depository fees and expenses for any and all exchange by Sellers of their Ordinary Shares received as Stock Consideration into American Depositary Shares of Parent.

10.6 *D&O Insurance.* As long as either Kwang Jun Yun or Sangwoo Han serves, as a director or officer, the Company, Parent and Purchaser shall maintain in effect directors' and officers' liability insurance covering the directors and officers of the Company and its subsidiary on terms customary in the relevant industry and jurisdiction.

## 11. Conditions for the Benefit of Purchaser and Parent.

All obligations of Purchaser and Parent to take the actions required to be taken by them at Closing are subject to the fulfillment or waiver, in whole or in part, of each of the following conditions on or before the Closing Date:

11.1 *Representations and Warranties.* Subject to additions and deletions occurring in the Ordinary Course of Business, none of which individually or in the aggregate shall have had a Material Adverse Effect, all representations and warranties made by Sellers and the Company herein shall be true and correct in all material respects (except those representations and warranties qualified by “materiality” or words of similar meaning, which must be true and correct in all respects) as of the date hereof and as of the Closing Date, with the same force and effect as though such representations and warranties had been made as of the Closing Date. In addition, all representations and warranties made by Sellers in the Investment Agreement shall be true and correct in all material respects as of the Closing Date. In connection therewith, the Company and the Sellers’ Representative shall deliver to Parent and Purchaser a certificate to such effect on the Closing Date.

11.2 *Fulfillment of Covenants.* All of the covenants, terms and conditions of this Agreement to be complied with by Sellers and the Company on or before the Closing Date shall have been complied with in all material respects. In connection therewith, the Company and the Sellers’ Representative shall deliver to Parent and Purchaser a certificate to such effect on the Closing Date.

11.3 *Third Party Authorizations.* Sellers and the Company shall have received all Permits necessary to validly sell and assign the Purchased Shares to Purchaser and to otherwise perform its obligations under this Agreement.

11.4 *Employment Agreement.* Messrs. Kwang Jun Yun and Sangwoo Han shall each have executed a service agreement in form and substance satisfactory to Purchaser attached hereto as *Exhibit 11.4(a)* (the “**Service Agreement of Kwang Jun Yun**”) and *Exhibit 11.4(b)* (the “**Service Agreement of Sangwoo Han**”), respectively (collectively, the “**Service Agreements**”), and neither of such individuals have taken any action to rescind such acceptance of continued employment, contingent on the Closing.

11.5 *Escrow Agreement.* Sellers shall have executed the Escrow Agreement pursuant to Section 5, and Sellers shall have filed a report to the Bank of Korea with respect to the Escrow Agreement and received acceptance of such report.

11.6 *Investment Agreement.* The Ordinary Share Recipients shall have executed and delivered to Parent the Investment Agreement pursuant to Section 4.1, and such Investment Agreement shall remain in full force and effect at the Closing Date.

11.7 *Consensus; Preferred Conversion; Stock Options.* Holders of Ninety Eight percent (98.0%) of the Company Shares shall have (i) executed this Agreement and not taken any action to rescind their execution or (ii) executed a binding power of attorney in favor of the Sellers’ Representative for his execution on their behalf. All of the Company Options listed in *Schedule 2.2(d)* which are not Unvested Company In-the-Money Options shall have been exercised or cancelled, and all corresponding Company Common Shares shall have been validly and properly issued. The ESOP shall have distributed the Company Shares subject to the ESOP to the individual holders thereof, other than those Excluded Shares set forth on *Schedule 1.45*. One hundred percent (100%) of those individuals set forth on *Schedule 1.45* shall have executed an agreement including a power of attorney in favor of Purchaser, attached as *Exhibit 11.7*, giving Parent and Purchaser the right to purchase each of such Excluded Shares held by those individuals at the Per Share Consideration, as soon as such a purchase would be permitted under applicable Law and the operative provisions of the ESOP.

11.8 *Proprietary Information and Inventions Agreement.* All employees of the Company shall have executed an inventions assignment agreement substantially in the form attached hereto as *Exhibit 11.8* (the “**Proprietary Information and Inventions Agreement**”).



11.9 *Resignation of Directors and Statutory Auditor.* All existing members of the board of directors and the statutory auditor of the Company, other than Kwang Jun Yun, shall have submitted their respective resignations in the form attached hereto as *Exhibit 11.9* (the “**Resignation Letter**”). Purchaser will have received the Resignation Letters of all of the members of the board of directors and the statutory auditor of the Company.

11.10 *Opinion of Counsel.* Purchaser shall have received the opinion of Yoon Yang Kim Shin & Yu, counsel for Sellers and the Company, dated as of the Closing Date substantially in the form of *Exhibit 11.10*.

11.11 *Non-Competition Agreements.* Parent shall have received an executed Non-Competition Agreement from each of the persons listed in *Schedule 11.11*, which Non-Competition Agreements shall be substantially in the form attached hereto as *Exhibit 11.11* (the “**Non-Competition Agreement**”).

## 12. *Conditions for the Benefit of Sellers.*

All obligations of Sellers hereunder to take the actions required to be taken by them at the Closing are subject to the fulfillment or waiver, in whole or in part, of each of the following conditions on or before the Closing Date:

12.1 *Representations and Warranties.* All representations and warranties made by Purchaser and Parent herein shall be true and correct in all material respects (except those representations and warranties qualified by “materiality” or words of similar meaning, which must be true and correct in all respects) as of the date hereof and as of the Closing Date, with the same force and effect as though such representations and warranties had been made as of the Closing Date. In connection therewith, Parent and Purchaser shall deliver to Sellers’ Representative a certificate to such effect on the Closing Date.

12.2 *Fulfillment of Covenants.* All of the covenants, terms and conditions of this Agreement to be complied with by Purchaser and/or Parent on or before the Closing Date shall have been complied with in all material respects. In connection therewith, Parent and Purchaser shall deliver to the Sellers’ Representative a certificate to such effect on the Closing Date.

12.3 *Grant of New Restricted Stock Units.* Parent shall have prepared grants to those employees of the Company set forth on *Schedule 10.4* new restricted stock units under the Parent Plan in the amounts set forth on *Schedule 10.4*; such restricted stock grants shall be delivered immediately after the Closing.

12.4 *Approvals and Consents.* Purchaser shall have obtained, given or made any and all of the consents and approvals set forth on *Schedule 8.5* (other than those to be obtained, given or made after the Closing), including without limitation filing of a report of foreign investment as provided in Section 10.2 and receipt of acceptance of such report from the applicable Korean authorities.

12.5 *Service Agreement.* Purchaser shall have executed each of the Service Agreements and have not taken any action to terminate, cancel, amend or modify such agreement, contingent on the Closing.

12.6 *Non-Competition Agreements.* Parent shall have executed the Non-Competition Agreements described in Section 11.11.

12.7 *Escrow Agreement.* Purchaser and Parent shall have executed the Escrow Agreement pursuant to Section 5.

12.8 *Investment Agreement.* Parent and Purchaser shall have executed and delivered to the Ordinary Share Recipients the Investment Agreement pursuant to Section 4.1, and such Investment Agreement shall remain in full force and effect at the Closing Date.

12.9 *Replacement Option Agreement.* Parent shall have executed and delivered to each of the holders of the Unvested Company In-the-Money Options the Replacement Option Agreement, and such Replacement Option Agreement shall remain in full force and effect at the Closing Date.

### 13. Indemnification.

13.1 *Indemnification by Sellers for Representations and Warranties and Covenants of the Company.* Except as set forth in Section 13.4 and subject to the limitations set forth in this Section 13, Sellers shall jointly and severally indemnify and hold harmless Purchaser and Parent against and in respect of any and all Liabilities, losses, damages, claims, costs and expenses, including without limitation reasonable attorneys' fees (collectively, the "**Losses**") imposed on, sustained, incurred or suffered by Purchaser or Parent, whether in respect of third-party claims against the Company, Purchaser or Parent, claims among the Parties, or otherwise, arising out of, resulting from, or due to (i) any breach of or inaccuracy in any representation or warranty set forth in Section 7 for the period such representation or warranty survives or (ii) any breach, violation or non-fulfillment of any covenant or agreement of the Seller contained in this Agreement; *provided, however*, that each Seller shall be severally, and not jointly, liable for such portion of the Losses arising out of, resulting from or due to the foregoing, as exceeding the actual amount in the Escrow; *provided, further*, subject to the provisions of Section 13.2, that such amount shall not exceed Thirteen Million and Five Hundred Thousand U.S. Dollars (US\$13,500,000).

13.2 *Threshold and Cap.* Sellers shall indemnify and hold harmless the Company, Purchaser and Parent with respect to any Loss suffered by the Company, Purchaser or Parent under Sections 13.1 if, and only if, such Loss together with the aggregate of all Losses theretofore incurred by the Purchaser or Parent under such Sections shall exceed Nine Hundred Thousand U.S. Dollars (US\$900,000) (the "**Threshold**"), in which case Sellers shall be liable for the aggregate amount of all Losses suffered by the Purchaser or Parent, up to a maximum equal to the Escrow Amount; *provided, however*, any Losses suffered by Purchaser or Parent with respect to inaccuracy of the Projected Closing Balance Sheet as updated as of the Closing Date shall not be subject to such Threshold, but shall be subject to the threshold set forth in Section 2.3(g), and provided, further that any Losses suffered by the Purchaser or Parent with respect to fraud of the Company, or relating to Losses suffered as a result of breaches of the representations and warranties set forth in Sections 7.2, 7.24 and 7.26 shall be not be subject to the Threshold and shall be limited to the Purchase Price plus any Earn-Out actually paid to Sellers.

13.3 *Indemnification by Sellers for Representations and Warranties of Sellers.* Each Seller shall severally, and not jointly, indemnify and hold harmless Purchaser and Parent against and in respect of any and all Losses imposed on, sustained, incurred or suffered by Purchaser or Parent, whether in respect of third-party claims, claims among the Parties, or otherwise, solely arising out of, resulting from, or due to any misrepresentation or breach of warranty set forth in Section 6 (but only for misrepresentations or breaches of warranties by such Seller and not by other Sellers) if, and only if, such Losses together with the aggregate of all Losses theretofore incurred by the Purchaser or Parent under this Section 13 shall exceed the Threshold, in which case such Seller shall be liable for the aggregate amount of all such Losses solely arising out of, resulting from, or due to its misrepresentation or breach of warranty set forth in Section 6. The indemnification obligations of each Seller other under this Section 13.3 shall be limited to the total amount of the Purchase Price received by such Seller as shown on *Schedule 2.2(f)*, except in the case of fraud, where no such limitation shall be in effect.

13.4 *Indemnification by Purchaser and Parent for Their Representations and Warranties.* Purchaser and Parent shall jointly and severally indemnify, defend and hold harmless Sellers (and their respective heirs, successors and permitted assigns) from, against and in respect of any Losses imposed on, sustained, incurred or suffered by, or asserted against, any of Sellers, whether in respect of third-party claims, claims among the Parties, or otherwise, arising out of, resulting from, or due to (i) any breach of or inaccuracy in any representation or warranty set forth in Section 8 for the period such representation or warranty survives or (ii) any breach, violation or non-fulfillment of any covenant or agreement of Purchaser or Parent contained in this Agreement.

#### 13.5 *Third-Party Claim Indemnification Procedure.*

(a) If any written claim or demand, for which an indemnifying Party (an "**Indemnifying Party**") may have liability to any indemnified Party hereunder (an "**Indemnified Party**"), is asserted against or sought to

be collected from any Indemnified Party by a third party (a “**Third-Party Claim**”), such Indemnified Party shall promptly (but no later than thirty (30) calendar days after receipt thereof) notify the Indemnifying Party in writing of such Third-Party Claim (a “**Third-Party Claim Notice**,”); **provided, however**, that the failure timely to give a Third-Party Claim Notice shall affect the rights of an Indemnified Party hereunder only to the extent that such failure has a material prejudicial effect on the defenses or other rights available to the Indemnifying Party with respect to such Third-Party Claim. A Third-Party Claim Notice shall contain a brief summary of the facts underlying or relating to such claim to the extent then known by the Indemnified Party or a copy of any correspondence or notice received from the relevant third party and a statement that the Indemnified Party seeks indemnification for Losses relating to such Third-Party Claim.

(b) The Indemnifying Party shall have thirty (30) calendar days (or such lesser number of days set forth in the Third-Party Claim Notice as may be required by any Governmental Authority or Governmental Order) after receipt of the Third-Party Claim Notice (the “**Notice Period**”) to notify the Indemnified Party that it desires to defend the Indemnified Party against such Third-Party Claim unless the Third Party Claim involves criminal liability or in which equitable relief is sought against any of the Indemnified Parties; *it being understood that*, by assuming the defense of a Third-Party Claim, the Indemnifying Party shall acknowledge its obligation to indemnify the Indemnified Party with respect to all Losses imposed on, sustained, incurred or suffered by, or asserted against the Indemnified Party in respect of such Third-Party Claim (subject only to the limitations contained in Section 13.2 or 13.3, as the case may be, and any amounts actually recovered as contemplated by Section 13.8) and all Losses sustained, incurred or suffered by the Indemnified Party in connection with such defense prior to such assumption shall be reimbursed by the Indemnifying Party.

(c) In the event that the Indemnifying Party notifies the Indemnified Party within the Notice Period that it desires to defend the Indemnified Party against a Third-Party Claim, the Indemnifying Party shall have the right to defend the Indemnified Party by appropriate proceedings, with counsel selected by the Indemnifying Party that is reasonably satisfactory to the Indemnified Party, at the expense of the Indemnifying Party. Once the Indemnifying Party has duly assumed the defense of a Third-Party Claim, the Indemnified Party shall have the right, but not the obligation, to participate in any such defense, including the opportunity to participate in any discussions or correspondence with any Governmental Authority, and to employ separate counsel of its choosing. The Indemnified Party shall participate in any such defense at its own expense unless (i) the Indemnifying Party and the Indemnified Party are both named parties to the proceedings and counsel to the Indemnified Party shall have reasonably concluded that representation of both parties by the same counsel would be inappropriate due to actual or potential differing interests between them or the availability to the Indemnified Party of one or more defenses or counterclaims that are inconsistent with one or more of those that may be available to the Indemnifying Party in respect thereof, or (ii) the Indemnified Party assumes the defense of a Third-Party Claim after the Indemnifying Party has failed to diligently pursue a Third-Party Claim it has assumed, as provided in Section 13.5(d).

(d) If the Indemnifying Party (i) elects not to defend the Indemnified Party against a Third-Party Claim, whether by not giving the Indemnified Party timely notice of its desire to so defend or otherwise, (ii) is not entitled to defend the Third-Party Claim as provided in Section 13.5(b), or (iii) after assuming the defense of a Third-Party Claim, fails to take reasonable steps necessary to negotiate for settlement or defend diligently such Third-Party Claim within fifteen (15) calendar days after receiving written notice from the Indemnified Party to the effect that the Indemnifying Party has so failed, the Indemnified Party shall have the right, but not the obligation, to assume its own defense; *it being understood that* the Indemnified Party’s right to indemnification for a Third-Party Claim shall not be adversely affected by assuming the defense of such Third-Party Claim.

(e) Whether or not the Indemnifying Party shall have assumed defense of a Third-Party Claim, (i) the Indemnified Party shall have no liability with respect to any settlement or compromise of such Third-Party Claim effected without its written consent (which consent shall not be unreasonably withheld) and (ii) the

Indemnifying Party shall not, without the prior written consent of the Indemnified Party (which consent shall not be unreasonably withheld), consent to the entry of judgment, admit any liability with respect to, settle, compromise, discharge or offer to settle, compromise or discharge any Third-Party Claim on a basis that would result in (A) the imposition of a consent order, injunction or decree that would restrict the future activity or conduct of the Indemnified Party or any of its affiliates, (B) a finding or admission of a violation of Law or violation of the rights of any Person by the Indemnified Party or any of its affiliates, (C) a finding or admission of a violation of Law, of a violation of the rights of any Person or that would have an adverse effect on other claims made or threatened against the Indemnified Party or any of its affiliates, or (D) except to the extent within the basket set forth in Section 13.2 or 13.3, as the case may be, any monetary liability of the Indemnified Party that will not be promptly paid or reimbursed by the Indemnifying Party or anything less than a complete release being provided to the Indemnified Party and its affiliates.

(f) The Indemnified Party and the Indemnifying Party shall cooperate in order to ensure the proper and adequate defense of a Third-Party Claim, including by providing access during regular business hours to each other's relevant business records and other documents, and employees; **provided, however,** that such cooperation shall not unreasonably interfere with the business or operations of the providing party. All Losses sustained, incurred or suffered by the Indemnified Party in connection with responding to, complying with or satisfying the Indemnifying Party's requests for cooperation shall be promptly reimbursed by the Indemnifying Party. If the Indemnifying Party disputes the amount of, or otherwise refuses or fails to reimburse, any such Losses that the Indemnified Party has incurred and for which the Indemnified Party has sought reimbursement from the Indemnifying Party, the Indemnified Party shall not be obligated to continue providing cooperation with respect to the defense of the relevant Third-Party Claim until such dispute has become the subject of a Final Determination or all such Losses have been reimbursed in full.

(g) The Indemnified Party and the Indemnifying Party shall use reasonable best efforts to avoid production of confidential information (consistent with applicable Law), and to cause all communications among employees, counsel and others representing any party to a Third-Party Claim to be made so as to preserve any applicable attorney-client or work-product privileges.

### 13.6 Direct Claim Indemnification Procedure.

(a) If an Indemnified Party wishes to make a claim for indemnification hereunder for a Loss that does not result from a Third-Party Claim (a "**Direct Claim**"), the Indemnified Party shall notify the Indemnifying Party in writing of such Direct Claim (a "**Direct Claim Notice**"), including a brief summary of the facts underlying or related to such claim to the extent then known by the Indemnified Party and a statement that the Indemnified Party seeks indemnification for Losses relating to such claim. The Indemnifying Party shall have a period of thirty (30) calendar days within which to respond to such Direct Claim.

(b) If the Indemnifying Party accepts the Direct Claim or does not respond within such 30-day period, the Indemnifying Party will be deemed to have accepted the Direct Claim and to have conclusively acknowledged its obligation to indemnify the Indemnified Party with respect to all Losses imposed on, sustained, incurred or suffered by, or asserted against the Indemnified Party in respect of such Direct Claim. If the Indemnifying Party accepts or is deemed to accept the Direct Claim, within thirty (30) days after the date of such acceptance, it shall pay the amount of Losses (if any) specified in the Direct Claim Notice for which the Indemnified Party seeks indemnification at that time (which amount shall not be conclusive of the final amount of such Direct Claim). In the event that the Indemnifying Party is Sellers or the Company, it shall have the option to either pay the foregoing amount of Losses in cash or instruct the Escrow Agent to release to Purchaser such portion of the Escrow Amount pursuant to the Escrow Agreement as directed by the Sellers' Representative.

(c) If the Indemnifying Party rejects all or any part of the Direct Claim within the 30-day period after the date of the Direct Claim Notice, or fails to pay any Losses in accordance with Section 13.6(b), the

Indemnifying Party and the Indemnified Party shall use good faith efforts to resolve such dispute on the Direct Claim during the 30-day period following the delivery of a response reflecting such dispute. If the dispute is not resolved within such 30-day period, the Indemnifying Party and the Indemnified Party shall submit the dispute to arbitration pursuant to Section 16.11 below.

13.7 *Consequential Damages.* The Parties acknowledge that Losses shall not include any consequential, punitive, special, incidental and indirect damages, including lost profits.

13.8 *Adjustments to Losses.*

(a) *Insurance.* In calculating the amount of any Loss, the proceeds actually received by the Indemnified Party or any of its affiliates under any insurance policy or pursuant to any claim, recovery, settlement or payment by or against any other Person in each case relating to the Third-Party Claim or the Direct Claim, net of any actual costs, expenses or premiums incurred in connection with securing or obtaining such proceeds, shall be deducted, except to the extent that the adjustment itself would excuse, exclude or limit the coverage of all or part of such Loss. The Indemnified Party shall make commercially reasonable efforts to assert any rights or make any claim or demand under any insurance policy relating to any Third-Party Claim or Direct Claim or any occurrence, claim or Loss that results in a payment by an Indemnifying Party under this Section 13.8. No Indemnifying Party shall be entitled to be subrogated to any rights of an Indemnified Party.

(b) *Net Asset Adjustment.* In calculating the amount of any Loss for which Purchaser or Parent is entitled to indemnification hereunder, the amount of any reserve or other negative provision reflected in the Closing Net Asset Statement related to such Loss shall be deducted.

(c) *Reimbursement.* If an Indemnified Party recovers an amount from a third party in respect of a Loss that is the subject of indemnification hereunder after all or a portion of such Loss has been paid by an Indemnifying Party pursuant to this Section 13, the Indemnified Party shall promptly remit to the Indemnifying Party the excess (if any) of (i) the amount paid by the Indemnifying Party in respect of such Loss (or, where Sellers are the Indemnifying Party, any amount paid by the Escrow Agent pursuant to the Escrow Agreement), plus the amount actually received from the third party in respect thereof, less (ii) the full amount of Loss.

(d) *Payment by Escrow Agent.* If, pursuant to the Escrow Agreement, Purchaser or Parent receives an amount from the Escrow Agent in respect of a Loss that is the subject of indemnification by Sellers hereunder, neither Purchaser nor Parent shall be entitled to seek enforcement of its rights to indemnification directly against Sellers with respect to such amount. Notwithstanding anything to the contrary: (i) with respect to each release to Parent and/or Purchaser from the Escrow (other than any releases arising from a breach of Section 6 hereof, which shall be released only from the breaching Seller's portion of the Escrow), 12.0% thereof shall be released from the cash portion of the Escrow and 88.0% thereof shall be released from the share portion of the Escrow; and (ii) despite any appreciation of Parent's American Depositary Shares/Ordinary Shares, no release to Parent or Purchaser shall be made from the share portion of the Escrow if the cumulative amount of releases therefrom has reached or exceeded US\$13,500,000.

13.9 *No Right of Set-Off.* No Party shall have any right to set off any amounts owed under this Section 13 against any amounts (including, without limitation, any indemnification payment) owed under any other provision of this Agreement or any Ancillary Agreement.

14. *Survival of Representations, Warranties, Covenants and Indemnification Obligations.*

14.1 *General.* Subject to Section 14.2, all representations, warranties, covenants and indemnification obligations of the Sellers contained in this Agreement, or made pursuant hereto, shall survive the Closing and

any investigation at any time made by or on behalf of any other Party for a period of fifteen (15) months after the Closing Date; *provided, however*, that the breaches of representations, warranties covenants and indemnification obligations relating to fraud and as to the representations and warranties contained in Sections 7.1, 7.2, 8.1, 8.2 and 8.3 shall not terminate but shall continue indefinitely. If any such claim shall have been made in writing and in accordance with the provisions of Section 13 and the Escrow Agreement prior to such expiration, such expiration shall not affect or in any way impair the rights of a Party to indemnification in respect of the particular matter as to which the claim was made, whether or not the amount of indemnification to which a Party is entitled in respect of such matter shall have been determined prior to such expiration.

14.2 *Survival of Tax Liabilities.* Sellers' indemnification obligations with respect to Losses that result as a result of a breach of Section 7.24 relating to Taxes shall survive the Closing Date and any investigation of Purchaser until the expiration of the applicable statute of limitations.

#### 15. *Term and Termination.*

15.1 *Term.* This Agreement shall become effective from the date on which all of the BOK Reports have been filed with and accepted by the Bank of Korea.

15.2 *Termination.* This Agreement may be terminated at any time prior to the Closing:

(a) by written agreement of Purchaser, the Company and the Sellers' Representative;

(b) by Purchaser or Parent, by giving five (5) days' written notice of such termination to the Sellers' Representative, so long as neither Parent nor Purchaser is in material breach of its obligations under this Agreement, if on or prior to May 31, 2007: (i) Sellers fail to satisfy any of the conditions set forth in Sections 11.1, 11.2, and 11.6 or (ii) Sellers refuse to effect the Closing despite satisfaction of all of the conditions set forth in Sections 11 and 12.

(c) by the Sellers' Representative, by giving five (5) days' written notice of such termination to Parent and Purchaser, so long as Sellers are not in material breach of their obligations under this Agreement, if on or prior to May 31, 2007: (i) Parent or Purchaser fails to satisfy any of the conditions set forth in Sections 12.1, 12.2, 12.3, and 12.5 through 12.9 or (ii) Parent or Purchaser refuses to effect the Closing despite satisfaction of all of the conditions set forth in Sections 11 and 12; or

(d) by Parent, Purchaser or the Sellers' Representative alone by means of written notice if the Closing Date does not occur on or prior to May 31, 2007.

15.3 *Effects of Termination.* In the event of the termination of this Agreement in accordance with Section 15.2, this Agreement shall thereafter become void and have no effect, and no Party shall have any liability to the other Parties, except for the obligations of the Parties contained in this Section 15 and in Section 16 (and any related definitional provisions set forth in Section 1), and except that nothing in this Section 15 shall relieve any Party from liability for any breach of this Agreement that arose prior to such termination, for which liability the provisions of Section 13 shall remain in effect in accordance with the provisions and limitations of such Section.

#### 16. *Miscellaneous.*

16.1 *Election of Remedies.* Any waiver of any condition of Closing shall constitute an election of remedies, and the Party waiving such condition shall have no claim for any breach of this Agreement to the extent of such waiver.

## 16.2 Expenses.

(a) Each Party shall bear its own expenses (including without limitation legal and accounting fees) incurred in connection with the preparation and execution of this Agreement and the Ancillary Agreements and the consummation of the transactions contemplated hereby unless specifically provided otherwise in this Agreement or any Ancillary Agreement. For avoidance of doubt, all financial advisor, legal and accounting fees and expenses of the Company and Sellers shall be set forth as current liabilities on the Company Closing Balance Sheet and taken into account in the calculation of the Post-Closing Adjustment Amount.

(b) In the event that this Agreement is terminated by Purchaser or Parent pursuant to Section 15.2(b), should the Company, within twelve (12) months following the termination of this Agreement by Company, enter into a Company Acquisition (as defined below), the Company shall pay to Parent or Purchaser Three Million Five Hundred Thousand U.S. Dollars (US\$3,500,000). Such payment shall be made promptly, but in no event later than two (2) days after the consummation of such Company Acquisition.

(c) For the purposes of this Agreement, "Company Acquisition" shall mean any of the following transactions (other than the transactions contemplated by this Agreement); (i) a merger, consolidation, business combination, recapitalization, liquidation, dissolution or similar transaction involving the Company pursuant to which the shareholders of the Company immediately preceding such transaction hold less than 50% of the aggregate equity interests in the surviving or resulting entity of such transaction, (ii) a sale or other disposition by the Company of assets representing in excess of 50% of the aggregate fair market value of the Company's business immediately prior to such sale, or (iii) the acquisition by any person or group (including by way of a tender offer or an exchange offer or issuance by the Company), directly or indirectly, of beneficial ownership or a right to acquire beneficial ownership of shares representing in excess of 50% of the voting power of the then outstanding shares of capital stock of the Company.

(d) In the event that this Agreement is terminated by Sellers prior to the Closing pursuant to Section 15.2(c), Parent and Purchaser shall jointly and severally pay to Sellers Three Million Five Hundred Thousand U.S. Dollars (US\$3,500,000). Such payment shall be made promptly, but in no event later than fifteen (15) days after the date of such termination.

16.3 *Further Assurances.* Each Party shall from time to time execute and deliver all further documents and instruments and do all acts and things as the other Party may, either before or after the Closing Date, reasonably required in order to effectively carry out or better evidence or perfect the full intent and meaning of this Agreement.

16.4 *Entire Agreement.* This Agreement (including all Schedules and Exhibits hereto) and the agreements referred to in or contemplated by this Agreement constitute the entire understanding and agreement among the Parties and supersede any and all prior or contemporaneous, oral or written, representations, communications, understandings and agreements among the Parties with respect to the subject matter hereof or thereof to the extent inconsistent with or contradictory to this Agreement or such other agreements.

16.5 *Incorporation by Reference.* The Schedules attached hereto or referred to herein are deemed to be a part of this Agreement and are incorporated herein by reference.

16.6 *Modifications.* This Agreement shall not be modified, amended, canceled or altered in any way, and may not be modified by custom, usage of trade or course of dealing, except by an instrument in writing signed by all Parties. All amendments or modifications of this Agreement shall be binding upon the Parties despite any lack of consideration so long as the same shall be in writing and executed by the Parties.

16.7 *Waiver.* The performance of any obligation required of a Party hereunder may be waived only by a written waiver signed by the other Parties, and such waiver shall be effective only with respect to the specific

obligation described. The waiver by any Party of a breach of any provision of this Agreement by any other Party shall not operate or be construed as a waiver of any subsequent breach of the same provision or another provision of this Agreement.

16.8 *Assignment*. Neither this Agreement nor any right or obligation hereunder may be assigned by any Party without the prior written consent of the other Parties, and any attempted assignment without the required consents shall be void.

16.9 *Severability*. If any provision hereof is found invalid, illegal or unenforceable pursuant to any Governmental Order, the remainder of this Agreement shall remain valid, legal and enforceable according to its terms, and such invalid, illegal or unenforceable provision shall be replaced with a provision that approximates the substance and spirit of the invalid, illegal or unenforceable provision as closely as possible without being invalid, illegal or unenforceable.

16.10 *Governing Law*. This Agreement and all disputes arising out of or in connection with this Agreement shall be governed by, interpreted under, and construed and enforceable in accordance with, the laws of the State of New York, U.S.A., without giving effect to conflict of law principles.

16.11 *Arbitration*. Any dispute, controversy or difference arising among the Parties out of or in relation to this Agreement or for the breach thereof shall be resolved exclusively by arbitration in the Hong Kong Special Administrative Region of the Peoples' Republic of China. Such arbitration shall be conducted in the English language in accordance with the Rules of Arbitration of the International Chamber of Commerce by three (3) arbitrators, of whom one shall be appointed by Purchaser and/or Parent, another shall be appointed by Sellers, and the third shall be appointed by the first two (2) arbitrators. If the third arbitrator is not so appointed within one (1) month after the appointment of the first two (2) arbitrators, the third arbitrator shall be selected in accordance with the Rules of Arbitration of the International Chamber of Commerce. The decision of the arbitrators shall be made on the principles of majority rule. The award made by the arbitrators shall be final and binding upon the Parties and may be enforced in any court of competent jurisdiction. Notwithstanding the foregoing provision, the Parties shall have the right to bring judicial proceedings to obtain preliminary injunctive relief at any time during the pendency of arbitration proceedings, provided that such preliminary injunctive relief shall be subject to final arbitral decisions. Unless the arbitrators decide otherwise, the cost of arbitration shall be shared equally by Purchaser and/or Parent, on the one hand, and Sellers, on the other hand.

16.12 *Notices*. All notices, demands, requests, consents or other communications hereunder shall be in writing and shall be given by personal delivery, by express courier, by registered or certified mail with return receipt requested, or by telex or facsimile, to the Parties at the addresses shown below, or to such other address as may be designated by written notice given by any Party to the other Parties. Unless conclusively proved otherwise, all notices, demands, requests, consents or other communications hereunder shall be deemed effective upon delivery if personally delivered, five (5) days after dispatch if sent by express courier, ten (10) days after dispatch if sent by registered or certified mail with return receipt requested, or confirmation of the receipt of the facsimile by the recipient if sent by telex or facsimile.

(a) If to Purchaser or Parent, to:

Silicon Motion Technology Corporation  
No 20-1 Taiyuan Street  
Jhubei City  
Hsinchu County, 302  
Taiwan  
Attention: Chief Executive Officer  
Facsilime: 886 3 552 6988



With a copy to:

Kirkpatrick & Lockhart Preston Gates Ellis LLP  
925 Fourth Avenue, Suite 2900  
Seattle, WA 98104-1158  
U.S.A.  
Attention: Christopher H. Cunningham  
Facsimile No.: 1-206-370-6040

With an additional copy to:

Kim & Chang  
223 Naeja-dong, Jongno-gu  
Seoul 110-720  
Korea  
Attention:  
Facsimile No.:

(b) if to the Company or the Sellers' Representative, to:

FCI Inc.  
11/F, KINS Tower  
25-1 Jeongja-dong, Bundang-gu  
Sungnam-si, Kyunggi-do 463-811  
Korea  
Attention: Kwang Jun Yun  
Facsimile No.: 82-31-711-0313

With a copy to:

Paul, Hastings, Janofsky & Walker  
21-22/F, Bank of China Tower  
1 Garden Road  
Central, Hong Kong  
Attention: Jong Han Kim  
Facsimile No.: 852-2867-9976

With an additional copy to:

Yoon, Yang, Kim, Shin & Yu  
23/F, ASEM Tower  
159-1 Samsung-dong, Gangnam-gu  
Seoul 135-798  
Korea  
Attention: Young Jae Shin  
Facsimile No.: 82-2-6003-7800

16.13 *Counterparts*. This Agreement may be executed in one or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

16.14 *Captions*. The section headings and captions contained herein are for purposes of reference and convenience only and shall not in any way affect the meaning or interpretation of this Agreement.

16.15 *Number and Gender.* Whenever used in this Agreement, the singular terms shall include the plural and the plural the singular, and the use of any gender shall be applicable to all genders.

16.16 *Confidentiality.*

(a) No Party shall disclose, disseminate or cause to be disclosed the terms and conditions of this Agreement, except insofar as disclosure is reasonably necessary to carry out and effectuate the terms of this Agreement or as required by a court of competent jurisdiction or governmental agency, and insofar as any Party is required by Law to disclose.

(b) Purchaser shall treat as confidential and shall safeguard any and all information, knowledge or data included in any information relating to the business of the Seller and its affiliates other than the Business that becomes known to Purchaser as a result of the transactions contemplated by this Agreement except as otherwise agreed to by the Seller in writing, in each case by using the same degree of care, but no less than a reasonable standard of care, to prevent the unauthorized use, dissemination or disclosure of such information, knowledge and data as Purchaser used with respect to its own confidential information; provided, however, that nothing in this Section 16.16 shall prevent the disclosure of any such information, knowledge or data to any Representatives of Purchaser who reasonably need to know such information for the purposes of negotiating this Agreement and carrying out the transactions contemplated hereby.

(c) Purchaser, Parent and Sellers acknowledge that the confidentiality obligations set forth herein shall not extend to information, knowledge and data that is publicly available or becomes publicly available through no act or omission of the party owing a duty of confidentiality, or becomes available on a non-confidential basis from a source other than the party owing a duty of confidentiality so long as such source is not known by such party to be bound by a confidentiality agreement with or other obligations of secrecy to the relevant other Party or required to be disclosed by a Governmental Authority.

(d) In the event of a breach of the obligations hereunder by Purchaser, Parent or Sellers, the non-breaching Parties, in addition to all other available remedies, will be entitled to injunctive relief to enforce the provisions of this Section 16.16 in any court of competent jurisdiction.

16.17 *Language.* The English language shall be the language used for the interpretation of this Agreement.

17. *Parent Guarantee.*

17.1 Parent hereby unconditionally guarantees the due and punctual payment and performance of all of Purchaser's obligations set forth in this Agreement. This guaranty is an irrevocable guaranty of payment (and not just of collection) and shall continue in effect notwithstanding any extension or modification of the terms of this Agreement, any assumption of any such guaranteed obligation by any other party or any other act or event that might otherwise operate as a legal or equitable discharge of Parent under this Section 17. So long as any obligation of Purchaser to Sellers under this Agreement remains unpaid or undischarged, Parent hereby waives (but only with respect to Sellers and not as to any other parties) all rights to subrogation arising out of any payment by Parent under this Section 17.

17.2 The obligations of Parent hereunder shall be absolute and unconditional irrespective of the validity, legality or enforceability of this Agreement or any other document related hereto, and shall not be affected by or contingent upon (a) the liquidation or dissolution of, or the merger or consolidation of Purchaser with or into any corporation, or any sale or transfer by Purchaser of all or part of its property or assets, (b) the bankruptcy, receivership, insolvency, reorganization or similar proceedings involving or affecting Purchaser, (c) any modification, alteration, amendment or addition of or to this Agreement, or (d) any disability or any other defense of the Purchaser or any other person and any other circumstance whatsoever (with or without notice to or knowledge of Parent) which may or might in any manner or to any extent vary the risks of Parent or might otherwise constitute a legal or equitable discharge of a surety or a guarantor or otherwise.

17.3 Parent hereby waives all special suretyship defenses and protest, notice of protest, demand for performance, diligence, notice of any other action at any time taken or omitted by Sellers and, generally, all demands and notices of every kind in connection with this Section 17 and the Purchaser's obligations hereby guaranteed, and which Parent may otherwise assert against Sellers.

17.4 This Section 17 shall continue to be effective or shall be reinstated, as the case may be, if at any time payment or performance of any of the obligations of the Purchaser under this Agreement is rescinded or must otherwise be restored or returned by Sellers upon the insolvency, bankruptcy or reorganization of the Purchaser or otherwise.

17.5 Parent acknowledges that each of the waivers set forth above is made with full knowledge of its significance and consequences and under the circumstances the waivers are reasonable and not contrary to public policy. If any of said waivers is determined to be contrary to any applicable law or public policy, such waivers shall be effective only to the extent permitted by Law.

*[remainder of page intentionally blank]*

**SIGNATURE PAGE—SHARE PURCHASE AGREEMENT**

IN WITNESS WHEREOF, the Parties have signed or caused their respective duly authorized officers to sign this Agreement, all as of the date first written above.

**SILICON MOTION TECHNOLOGY CORPORATION**

By: /s/ Wallace Kou  
Name: Wallace Kou  
Its: President

**LAKE TAHOE INVESTMENT CORPORATION**

By: /s/ Wallace Kou  
Name: Wallace Kou  
Its: Director

**FCI INC.**

By: /s/ Kwang Jun Yun  
Name: Kwang Jun Yun  
Its: CEO/President

**SELLERS' REPRESENTATIVE**

/s/ Kwang Jun Yun  
Kwang Jun Yun

**SELLERS:**

Signature of each of the persons and entities set forth on *Schedule A*

## CERTIFICATIONS

I, Wallace C. Kou, certify that:

1. I have reviewed this annual report on Form 20-F of Silicon Motion Technology Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;
4. The company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the company and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of company's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

Date: July 2, 2007

---

/s/ WALLACE C. KOU  
Wallace C. Kou,  
Chief Executive Officer

## CERTIFICATIONS

I, Riyadh Lai, certify that:

1. I have reviewed this annual report on Form 20-F of Silicon Motion Technology Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;
4. The company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the company and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
5. The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of company's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

Date: July 2, 2007

/s/ RIYADH LAI  
Riyadh Lai,  
Chief Financial Officer

## CERTIFICATION

Pursuant to 18 U.S.C. Section 1350, the undersigned each hereby certifies that, to his knowledge, the annual report on Form 20-F of Silicon Motion Technology Corporation for the year ended December 31, 2006 fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934, and that the information contained in the such report fairly presents, in all material respects, the financial condition and results of operations of Silicon Motion Technology Corporation.

Date: July 2, 2007

/s/ WALLACE C. KOU

---

**Wallace C. Kou,**  
**Chief Executive Officer**

/s/ RIYADH LAI

---

**Riyadh Lai,**  
**Chief Financial Officer**

The foregoing certification is being furnished solely pursuant to 18 U.S.C. Section 1350 and is not being filed as part of the Report or as a separate disclosure document.

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the Registration Statements No. 333-131219 and No. 333-142422 on Form S-8 of our report dated April 30, 2007, relating to the financial statements of Silicon Motion Technology Corporation appearing in this Annual Report on Form 20-F of Silicon Motion Technology Corporation for the year ended December 31, 2006.

/s/ Deloitte & Touche

Taipei, Taiwan  
Republic of China  
June 29, 2007